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World trade in 2020: The show must go on! COVID-19 pandemic, trade wars and deadlock at the WTO: Rules-based trade is under pressure and the EU must take the lead

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IW-Policy Paper 9/2020

World Trade in 2020: The show must go on!

COVID-19 pandemic, trade wars and deadlock at the WTO: Rules-based trade is under pressure and the EU must take the lead

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Brussels, 28.04.2020

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JEL-Classification

F13 – Trade Policy, International Trade Organizations

F02 – International Economic Order and Integration

H12 – Crisis Management

Abstract

Rules-based trade is under attack and the WTO is at risk of marginalization. The COVID-19 pandemic and its detrimental effects on public health, global supply- and value chains and industrial production, have brought back national export restrictions and stopped the free flow of goods and people. Buzz words such as ‘decoupling’, ‘sovereignty’ and ‘autarky’ quickly returned to the global stage. Meanwhile the World Trade Organization (WTO) is facing an existential crisis due to a deadlock in negotiations, blockage of institutional reforms and paralysis of the dispute settlement mechanism (DSM). However, this policy paper argues that there might be hope, with countries experiencing the effects of disrupted trade and understanding: *The show must go on!*

We are at crossroads: The global COVID-19 pandemic could either lead to more state interference, decoupling and a marginalization of global trade action or it calls for an unprecedented level of multilateral cooperation. This analysis claims that trade can serve as a powerful, low-cost, and immediate crisis response by securing the free flow of medical goods and personal protective equipment (PPE), lowering tariffs, and coordinating logistics. Second, trade will be essential for a speedy recovery of the global economy. Geographical diversification of supply- and value chains must not mean decoupling, and genuine COVID-19 measures to protect public health and security should not become a fig-leaf for protectionist policies.

However, there is no alternative to WTO reform, given that the economic balance in the world has changed – while the WTO has not. Besides institutional reforms, the WTO and its members now have the chance to update its rulebook and to advance future trade policy on services, digital trade/e-commerce, and sustainability, as well as to restore a functional enforcement and dispute settlement mechanism. The EU can act as an ‘honest broker’ between the USA and China. Establishing an interim appeal arbitration mechanism in early 2020, the EU and Canada have taken the first steps. Onwards, the EU should take the lead to form a like-minded coalition of progress and to become a global standard-setter of its own. Now more than ever, the WTO needs to adapt to internal- and external shocks:

The show must go on!

1 Introduction

The World Trade Organization (WTO) is facing an existential crisis: Deadlock in negotiations, blockage of institutional reform and paralysis of the dispute settlement mechanism (DSM). Rules-based trade is under attack and the WTO is at risk of marginalization. On top of it all, the COVID-19 pandemic and its detrimental effects on public health, global supply chains and industrial production, has brought back national export restrictions and stopped the free flow of goods and people. In the light of these challenges, one could be tempted to abandon the WTO as the global forum for rules-based trade and ultimately find oneself in an era of bi-/plurilateral agreements (at best) or Trumpian anarchical trade wars (at worst). However, there might be hope, with countries experiencing the effects of lockdowns, as well as disrupted value and supply chains and understanding: ***The show must go on!***

The global COVID-19 challenge shows why multilateral cooperation must be upheld. Most WTO member countries agree: The WTO is a valuable public good worth preserving. Overall, WTO membership has contributed to welfare gains in most member states and contributed to a total increase in prosperity of around \$ 855 billion between 1980 - 2016, according to Felbermayr et al. (2019). Most notably small countries such as Malta or South Korea, but also the big trading blocs USA (\$87 bn.), China (\$ 86 bn.) and (export driven) Germany (\$ 66 bn.), profited from the global trade regime, including the biggest income gains. WTO membership pays off, especially for the big three (USA, China, EU). Thus, why are they dismantling their own 'gold mine', and what could be done to stop and reverse this trend?

2 The World Trade Organization: Functions and Shortcomings

Since its foundation in 1995, the WTO (and before the GATT-regime) has served as the main forum to host negotiations between members on trade-related topics. Much of the WTO policymaking is taking place at technical level (often in WTO Committees). Initially, the WTO has been extremely successful in reducing tariffs by almost half (10.5 per cent to 6.4 per cent average tariffs), facilitating trade and growing in membership (WTO, 2020a). However, since the end of the Uruguay Round (1994), no major breakthrough was achieved, and the institution has lost relevance due to its failure to update the rulebook. Neither services, nor climate change/sustainability (i.e. Green Goods Agreement) or the digital revolution were met with multilateral trade rules. A minor exception being the update of the 1997 Information Technology Agreement (ITA) at the Nairobi Ministerial Conference in December 2015. Largely, regional Free Trade Agreements (FTAs) increased and the conflict between developed, emerging and developing countries intensified with the failure of the Doha Development Round (DDA). The world has changed - the WTO has not.

2.1 Monitoring and Dispute Settlement

Nonetheless, the WTO fulfilled rather reliably its second function of monitoring its members' trade policies. For example, notifications must be upheld by all WTO members and each country must undergo a periodic Trade Policy Review. Overall, transparency is important but enforcement even more. Therefore, the WTO had established a two-level Dispute Settlement Mechanism (DSM), consisting of (moderated) consultations and a first stage panel dispute settlement and a second appeals stage via the Appellate Body (AB). As is well-known by now, Washington finally froze the 25-year-old dispute settlement system last December by blocking appointments of new judges to the AB. Disputes are still being reviewed by panels, but now the Appellate Body no longer has enough members to hear appeals and therefore cannot make final judgements. Without a functional dispute settlement and enforcement, the WTO is set to become a paper tiger. While the US reaction to block the Appellate Body leaves Europeans somewhat shocked, it is clear that the WTO has not been equipped to deal with systemic changes, such as Chinese state capitalism. Chinese state subsidies forced technology transfer, Intellectual Property Rights infringements, and state-owned enterprises (SOEs) are challenging the liberal "understandings" of international trade. And perhaps even more crucially the on-going geo-economic rise of China has already led multiple countries to reassess these "understandings" and their respective cost-benefits-analysis of the WTO system (Mavroidis / Sapir, 2019).

2.2 Hope for Progress and Reforms?

Despite of the above, many countries still profit from their WTO membership and rely heavily on the global rules-based trading system. Most WTO members have not (yet) used the Dispute Settlement Mechanism (DSM) and the majority strongly supports a two-stage adjudication. There is criticism though, that the dispute settlement system fell victim to 'politicization' and 'polarization' in the past (Fiorini et al., 2019).

One of the main advocates of a two-stage adjudication and binding verdicts is the EU. While it cannot on its own re-instate the WTO's credibility, it can function as an 'honest broker' and mediate between conflicting parties as well as form like-minded coalitions. It already did persuade other members to establish a 'critical mass' of states to re-establish a functioning adjudication system. In January 2020, the EU, China and 15 other WTO members (i.e. Brazil, Canada, Mexico) established a temporary mechanism to settle trade disputes¹, open to any WTO member and "in place only and until a reformed WTO Appellate Body becomes fully operational" (WTO, 2020b). The interim mechanism, which is based on Article 25 of the WTO Dispute Settlement Understanding (DSU), did not replace the Appellate Body but it serves the same purpose. The multi-party interim mechanism retains a binding, impartial two-step dispute settlement system at the WTO. The initiative was spearheaded by the so-called Ottawa Group², a group of WTO members led by Canada and the EU, that have been pushing for WTO reform since 2018. Building on a bilateral interim appeal arbitration arrangement between Canada and the European Union (2019), they extended the mechanism to third countries.

2.3 The show must go on, but let us start with the 'side shows'

In order to make the WTO fit for the future, institutional reforms, an agreement on Special and Differentiated Treatment, concessions on agriculture and industrial subsidies, as well as a functional dispute-settlement are necessary. This will take time and political will. Meanwhile, like-minded states can still advance trade policy in the following fields:

- Creating trade rules for the fourth industrial revolution in digital trade/e-commerce;
- implementing the UN Sustainable Development Goals (SDGs) and the EU's Green Deal into trade rules, and further
- minimizing (non-tariff) trade barriers by harmonizing global standards (i.e. for green products, (digital) services).

Due to the fact that services are underrepresented in the WTO, accounting for only 25 per cent of rules while representing 75 per cent of the global economy (Kiener, 2019), the creation of an e-commerce/digital trade regime that modernizes guidelines for the digital era is essential to showcase the WTO as the main negotiating- and harmonization forum (inter alia for tariffs, standards, customs). A like-minded coalition, led by the EU, can advance trade rules for the fourth industrial revolution argue Nau et al. (2019). In this context, the EU is not only seen as an 'honest broker' but is also an influential global standard-setter (as seen with the General Data Protection Regulation, GDPR). Furthermore, the EU remains arguably the most open market in the world (if one neglects the strongly subsidized Common Agricultural Policy).

¹ Members: Australia, Brazil, Canada, China, Chile, Colombia, Costa Rica, European Union, Guatemala, Republic of Korea, Mexico, New Zealand, Norway, Panama, Singapore, Switzerland, Uruguay.

² Ottawa Group: Australia, Brazil, Canada, Chile, European Union, Japan, Kenya, South Korea, Mexico, New Zealand, Norway, Singapore, and Switzerland.

In order to guarantee the free-flow of data, openness, and digital standards, which are vital for the future of global value chains, key players in China and the USA with its GAF A-companies, need to be integrated. China has become a leader in digital business models and from 2001-2017, China's trade in services grew by 16.7 per cent, 2.7 times more than the world average, and in 2018 alone, mobile payments totaled \$ 41.5 trillion (China Daily, 2019). As seen during last year's trade war, the EU is the only player able to bridge the gap between liberal market economies and China. In its Joint WTO Statement on E-Commerce from January 2019 (WTO, 2019), and acknowledging its efforts in June 2019 to set this topic on top of the G20 agenda (G20, 2019), the EU has already portrayed its leadership ambitions and has gathered several like-minded countries. With its recent European Digital Strategy, including a comprehensive European Data Strategy (European Commission: 2020a), the EU makes clear that digital (trade) rules should cover issues from innovation, data spaces and the free flow of information to (digital) sovereignty, privacy and citizens' rights. Successful and pragmatic cooperation, paired with a functional interim dispute settlement and common Intellectual Property Rules, could function as a catalyst for WTO modernization. First progress has been achieved with the EU-China Working Group on WTO reform and their agreement at the EU-China Summit (April 2019) – before the COVID-19 pandemic - to conclude long-running talks about an investment agreement in Leipzig 2020. While this timeline might no longer be achievable, the Sino-EU cooperation seems nonetheless promising.

3 Outlook: COVID-19 and the next WTO Ministerial Conference

Reform of the WTO can wait no longer. The next chance could be this year's Ministerial Conference (MC-12 in Kazakhstan, date *tbc*) (WTO, 2020c). While the COVID-19 pandemic might make a (physical) meeting of trade ministers infeasible, the external shock of the Corona crisis will certainly lead to a major re-thinking of global value chains. Countries and companies will try to decrease dependency and seek to increase their resilience through geographical diversification. Prices and 'just-in-time'-production will be replaced as the only criteria, while globalization critics might gain more traction.

Overall, the International Monetary Fund estimates that the global health crisis could result in a 3 per cent decrease of global GDP this year (IMF, 2020). This recession will have severe effects on global trade. In Europe alone, it might lead to a decline of 9.2 per cent in EU exports and 8.8 per cent in EU imports from third countries in 2020, according to the EU Commission's DG Trade Chief Economist (2020). However, COVID-19 is not the first shock to global trade. The pandemic comes at a time when global trade has already suffered from several shocks, namely the China-US trade war, the blockage of the WTO Appellate Body and the ultimate weakening of global trade rules.

3.1 COVID-19 reinforces global trends

The global Corona-crisis and its effects on public health, supply chains and industry could reinforce three trends:

- **State vs. market:** First, the role of the state increases in trade policy during COVID-19. Export restrictions, national production plans and nationalizations lead to state-managed trade. Even within the EU Single Market, national trade action overshadowed a common approach and, temporarily, led to export restrictions for medical devices and uncoordinated border closures. For example, until 21st April 2020, 16 Schengen countries had notified the EU Commission on the reintroduction of controls at internal borders in order to stop the spread of Covid-19 (EPRS, 2020). Accordingly, buzz words such as ‘sovereignty’ and ‘autarky’ will soon return to global trade policy.
- **Decoupling:** Second, the trend towards decoupling started during the Sino-American trade dispute (Beer et al., 2019) and will now intensify with states trying to become more self-sufficient and less dependent on one country or region.
- **Marginalization of multilateral (trade) action:** Last, global trade is at risk of becoming nationalized and international institutions could lose influence. Currently, more and more countries are turning inwards, i.e. by implementing export restrictions (personal protective equipment (PPE), medical devices, medicines and even food supplies) or unilaterally closing borders for goods and (foreign) workers (WTO, 2020d). The danger is that genuine motives of public health and security are being abused. Measures to tackle COVID-19 could become a fig-leaf for protectionist policies.

3.2 Trade Policy as a crisis reaction and economic recovery tool

Countries turning inwards is somewhat ironic, given that we are confronted with a global health crisis and ultimately facing a global economic downward spiral. Global, multilateral action is needed. Already today the WTO can have an immediate impact. In times of the COVID-19 pandemic it becomes evident that global trade is vital to our survival and “trade can serve as a powerful, low-cost tool to improve access to medical supplies“, according to González (2020). Customs, supply chains and frictionless transport are essential for the global economy. Here, one must differentiate between a) immediate crisis response and b) trade action aimed at economic recovery:

■ Immediate crisis response.

Priority for trade is to keep the free flow of goods and services. While trade restrictions aimed at tackling COVID-19 challenges and securing public health are legally in line with WTO rules, they ultimately lead to reduced supplies and global price surges. Under the SPS Agreement (WTO, 1995a/2020), members have the right to restrict trade for the protection of human, animal or plant life or health. Besides, the TBT Agreement (WTO, 1995b/2020) allows members to implement measures to achieve the above mentioned legitimate policy objectives. However, COVID-19 needs a specific crisis response:

- First, global solidarity in times of COVID-19 means to remove trade restrictions (on medical devices, food supplies, medicine) and lower technical barriers to trade as soon as possible. National stock piling is the wrong approach!

- Second, transport and logistics are crucial. After more and more EU member states closed their borders, leading to bottleneck border crossings in Poland or Hungary, the European Commission (2020b) implemented so-called “green lanes” on 23rd March for free flow of essential products. Going through these “green lanes” border crossings, including any checks and health screening, should not exceed 15 minutes. While this illustrates a pragmatic action, trade will play a greater role in tackling COVID-19 and its economic challenges. Collective trade action is needed, and the WTO should become the main negotiating and coordinating forum.
- Third and most importantly, the WTO should lower tariffs and non-tariff barriers on pharmaceuticals, PPEs, medical devices, and other health-related products. The starting point could be the WTO Trade in pharmaceutical products (GATT, 1994) initiative, argues González (2020), who also advocates a medical services trade reform and trade facilitation for e-health services. The EU already has low tariffs on these products, thus the Directorate General Trade announced to allow EU member states to fully suspend import tariffs and Value Added Tax (VAT) on medical products. Besides, it is crucial to reduce export restrictions (i.e. on face masks, PPEs, medicines/ingredients). Germany has recently announced to gradually scale back export restrictions and EU Trade Commissioner Phil Hogan emphasized in his discussion with the European Parliament’s INTA Committee (on 21/04/2020) that these restrictive measures must only be temporary (European Parliament, 2020).
- **Trade action aimed at economic recovery.**

Trade will be essential for the recovery of the global economy. We are at crossroads: The COVID-19 pandemic calls either for decoupling or for an unprecedented level of multilateral cooperation. The WTO can profit from the momentum for collective action among the G20 states. It would be a strong sign of multilateralism and a first step towards ‘normal’, if governments could “collectively promote greater global alignment between public health and trade policies to save lives” (González, 2020) by using the WTO as the coordinating body. Furthermore, geographical diversification of supply- and value chains (i.e. for PPEs and pharmaceuticals) must not mean decoupling. Especially the EU and its export-champion Germany have a vital interest in restoring frictionless, rules-based and global trade, given that no other big industrial country is as intertwined with international supply and value chains, and relies as much on preliminary goods from abroad, as Germany (Kolev / Obst, 2020).

The WTO now has the chance to update its rulebook on services, digital trade/e-commerce, as well as on logistics/transport and to restore a functional enforcement and dispute settlement mechanism in order to enable a speedy recovery of the global economy. Trade is a powerful policy tool. Thus, the EU must take the lead, starting in its own Single Market, and then form a like-minded coalition for progress at the WTO.

Overall, the economic balance in the world has changed, the WTO needs to adapt due to internal- and external shocks.

There is no alternative: ***The show must go on!***

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