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Research Report

Ways out of the WTO's December crisis: How to prevent the open global trade order from unravelling

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SWP Comment

NO. 46 DECEMBER 2019

Ways Out of the WTO's December Crisis

How to Prevent the Open Global Trade Order from Unravelling

Laura von Daniels, Susanne Dröge and Alexandra Bögner

The World Trade Organization (WTO) is facing the biggest crisis since its inception in 1995. From 11 December, the committee that deals with WTO members' appeals, the Appellate Body, will be left with only one judge. New appointments have been blocked by the United States. This will incapacitate the Body because the minimum requirement for any decision is three judges. What seems to be a mere procedural issue will result in major disruptions for international trade relations and might ultimately lead to the unravelling of the existing global trade order. The EU and like-minded partners have three options to cope with the situation and to safeguard the WTO's role in trade dispute settlement. The EU and its partners could either endure the stalemate while aiming for a broader WTO reform. Or the EU could strive for an alternative appeals mechanism within the WTO, as an interim solution. The third option would be to seek dispute settlements outside of the WTO. None of the options comes without risk of failure since there is uncertainty about the US endgame, and each move could deliver proof for the US that the WTO no longer serves its interests.

In June 2017, US representatives to the WTO in Geneva began blocking the launch of a selection process for new members of the WTO's Appellate Body. This standing body conclusively settles disputes as a second tier in the WTO binding dispute settlement system. The Appellate Body is activated by member states in cases where a party objects to the initial findings of the first authority, the dispute settlement panel.

The terms of three Appellate Body members expired in 2017 and one has resigned, while the US continues to block new member appointments. The Body is now left with only three of its usual seven judges. The reduced number of judges is already

impairing the Appellate Body's ability to function as it struggles to keep up with the workload. According to WTO rules, the minimum number of judges required to serve on any case is three. The Body will, therefore, be unable to hear appeals when the terms of two of the remaining Appellate Body members expire on 10 December this year. This would be tantamount to a collapse of the second tier of the WTO's dispute settlement system.

Between 1995 and 2014, dispute parties appealed 67 percent of all panel reports. If the Appellate Body does become incapacitated, WTO members will be able to permanently block the adoption of any panel



rulings they object to by filing appeals that can no longer be heard. Under those circumstances, frustrated countries whose complaints remain in limbo may resort to taking unilateral countermeasures against alleged rule violations. As a result, disputes that are currently subject to the WTO dispute settlement mechanism might trigger spirals of retaliation and small-scale trade wars.

The WTO has two main pillars, one is the negotiation pillar which allows member states to change and add trade rules based on consensus from all member states. The second pillar is the dispute settlement system. Thus, such a forced shutdown of the system could eventually add to an unravelling of the global trade order.

The WTO crisis: a recap

A multitude of problems has been building up in the global trade regime over a period of almost three decades. The Trump administration's open rejection of the regime, culminating in a breakdown of the Dispute Settlement Mechanism (DSM) – unavoidable due to the required lead time of at least three months for new appointments – can also be traced back to these fundamentals. They include reform inertia in times of dynamic globalization and long-standing divisions between developing and developed countries.

From GATT to the WTO

In the 1990s, members of the General Agreement on Tariffs and Trade (GATT, 1947) concluded the Uruguay round of trade talks (1986–1994). This was the eighth successful round of talks on the liberalization of international trade in a row. Driven by the US under President Bill Clinton, the Uruguay round was eventually concluded and implemented, bringing about substantial changes and reform in the overall architecture and scope of the multilateral trade regime. The EU, Japan and South Korea backed the Uruguay round agenda, although

many developing countries did not. One major US objective was to curtail intellectual property theft by private and state-owned Chinese companies, but also securing patent rights for US firms active abroad (e.g. in pharmaceuticals and agriculture). This led to the TRIPS Agreement (Trade-Related aspects of Intellectual Property Rights) that was added to the GATT in 1994. Another breakthrough at the time was the General Agreement on Trade in Services (GATS) which facilitated liberalization of services. The round was eventually concluded in 1993 and signed by 123 governments in April 1994 in Marrakesh, Morocco. The delay was largely caused by the US and the EU disagreeing on agricultural trade, market access, services and anti-dumping rules, and also over the creation of a full-blown organization dedicated to world trade. In the end, the WTO replaced the GATT as an organization in 1995, and functions as umbrella for the reformed GATT (1994) and all other agreements that have existed as part of the negotiations since 1947.

The dispute settlement system had already been streamlined as a result of the early phase of negotiations in 1988, when it was decided to undertake a new systematic and regular review of national policies and practices under the Trade Policy Review Mechanism.

Legacy of the Uruguay Round

The Uruguay Round produced what is now known as a “built-in agenda” with further negotiations to follow after its conclusion. It also led to a change in the overall relations between developed and developing member states. The latter increased their activities in particular policy fields and became partners in a rising number of preferential trade agreements. India, a GATT founding member, has been the leading developing country throughout the trade rounds. After the Tokyo Round (1979) it led, together with Brazil, a group of developing countries who voiced strong objections against a new round in the early 1980s, while the G7 countries were pushing

strongly in that direction. Developing countries had two demands, a rollback on GATT-inconsistent measures and a standstill on new measures, which were mostly driven by the US. The speed and scope of the G7 measures driving this process clashed with the limited capacities of the developing countries, but they also helped form common areas of interest. With the Uruguay Round this changed. Brazil and India started lagging behind global integration processes, which other countries had opened up to – including China, which was an observer from 1984 onwards and applied to join the GATT in 1986.

The built-in agenda and the broadening of trade issues as backed by the US placed huge demands on most developing countries. The Doha Round, launched in November 2001, took up their calls for a new round combining the Marrakesh Agreement's commitments to reopen talks on agriculture and services. Due to the criticism voiced by developing countries during the earlier Uruguay Round, ministers decided to put development issues at the centre of negotiations (Doha Development Round).

During these talks, a group of 20 (WTO G20) larger developing country WTO members, including India, China, Indonesia and Mexico, openly challenged the dominance of the US and the EU in 2003 at the WTO Ministerial Conference in Cancún. While the EU pushed for the Singapore issues (amongst them government procurement, trade facilitation, trade and investment and trade and competition), the US called for industrial tariff reductions by developing countries in return for lowering agricultural tariffs.

In summer 2006, the talks collapsed, largely because the US, the EU, India, Brazil, Japan and Australia could not agree on agriculture (e.g. reduction of US subsidies) and on a reduction of industrial tariffs according to the Swiss Formula, a tool used to calculate the tariff reduction rate. It marked yet another example of the changed geo-political realities.

For years, the US has expressed numerous concerns it has with the multilateral

trade system, including the claiming of development country status by emerging economic champions like China and India. The US has also criticized the WTO's general inability to constrain market-distorting practices, such as subsidies and dumping, intellectual property theft and forced technology transfer, notably by China. WTO negotiations over these issues have been impeded by consensus requirements and, as the Trump administration argues, by "judicial activism" from the Appellate Body which encourages WTO members to seek privileges through litigation rather than negotiation.

Changing US views on trade with China

When China became a member of the WTO on 11 December 2001, its accession was initially applauded by free traders in both political parties in the United States. The Bill Clinton administration that had presided over the accession negotiations and much of the business community both expected huge benefits from declining import prices and hence production costs. Furthermore, the US was expecting large gains from entering Chinese services markets (telecommunications, finance, insurance).

Washington's decision to finally approve China's accession to the WTO was by no means rushed. The US government has granted the Chinese conditional normal trade relations (the equivalent of WTO's most favoured nation status) since 1979, subject to annual review and approval by Congress.

A decade later, criticism of China's accession to the WTO resurfaced in the US. What was mostly an academic debate about the size and significance of the "China shock" on local economic labour markets and growth, turned into a highly politicized debate on China's aggressive economic policy and its harmful economic effects on the US, and necessary countermeasures the government should take.

A turning point in US policy towards China had clearly been reached in Septem-

ber 2009, when President Barack Obama introduced tariffs to stop what he described as a “harmful surge” of Chinese tyre imports into the United States. The 2010 Trade Agenda noted several other Chinese trade practices that were hurting US companies, including unjustified restrictions on US exports of agricultural products, restrictions on winning distribution rights for American content companies in China, as well as Chinese export restrictions on raw materials needed by core US industrial sectors from steel and aluminium to chemicals.

Between 2009 and 2016, the United States Trade Representative (USTR) filed 13 WTO complaints against China — all successfully settled or ruled in favour of the US. Moreover, the Obama administration placed numerous anti-dumping and countervailing duties on Chinese goods starting in 2009. By September 2017, before Donald Trump came into office and placed unilateral tariffs of 25 percent on steel and 10 percent on aluminium in the spring of 2018, the measures taken earlier by the Obama administration were already shutting off Chinese steel imports from the US market almost entirely.

What angered Washington during the Obama years as much as now was the fact that since 2002, the Appellate Body had ruled against Washington’s use of trade remedies in several landmark decisions. Beijing successfully challenged Washington’s use of “zeroing”, a technique used to calculate dumping margins for imports that are taken as a basis for remedies. Also, the Appellate Body ruled against the US’s use of “double remedy”, i.e. the simultaneous placement of anti-dumping and countervailing measures on Chinese imports. The Obama administration took this as proof that the body was “overreaching”. Beyond its dissatisfaction with remedy decisions, the USTR has repeatedly argued that existing WTO rules are insufficient to take China to court for violations of intellectual property rights.

Donald Trump is the first US President to challenge China outside of the WTO framework. Not only has he repeatedly questioned

the global organization’s ability to deal with China’s trade practices. The path of unilateral trade measures applied against Beijing is evidence that Washington prefers to “go it alone on China” rather than to cooperate with other countries. The US approach clearly undermines the WTO by implementing unilateral US tariffs on Chinese imports and taking other non-trade measures and also by dealing with China almost entirely in bilateral rather than multilateral negotiations.

The US blockage of the Appellate Body

In 2016, due to its frustration with Appellate Body decisions against the US, the Obama administration blocked the reappointment of an Appellate Body member over a period of six months. The EU representative at the WTO in Geneva argued that the move was “unprecedented and poses a very serious threat to the independence and impartiality of current and future Appellate Body members.” Other members shared the EU’s criticism.

The Trump administration has justified its unilateral blockage of new appointments to the Appellate Body in 2017 with a series of long-standing US grievances against the body. One major concern relates to what the US considers to be a disregard by the Appellate Body for the rules agreed by WTO members, and its overreach in adding to or diminishing members’ rights and obligations. Notably, the US laments that Appellate Body interpretations of WTO rules on subsidies, antidumping duties and countervailing duties have significantly limited the US and other market economies’ ability to counter-act such trade-distorting practices, used mainly by China.

Thus, the US aims to keep national authority and control over the dispute settlement process firmly with WTO member states in order to prevent infringements on national sovereignty. US representatives have regularly pointed to these concerns to explain their continued blockage of the

selection process for new Appellate Body members. Procedural concerns, such as disregard for the 90-day deadline for reports by the Appellate Body and the occasional continued service of its members on cases beyond the expiration of their terms without explicit approval from WTO members, are often tied to substantive ones. Disregard for the time limit, for example, is problematic in the US view not only because it impedes the swift settlement of disputes, but also because it enables the Appellate Body to widen the scope of its reports instead of focusing solely on the issues on appeal. The US government seems to interpret a breach of procedural rules as facilitating overreach on substance.

Uncertainty about the US endgame

So far, the US has remained unmoved by two proposals to end its blockage of the Appellate Body, introduced by the EU and other WTO member states. At the WTO General Council meeting on 12 December 2018, the US argued that proposals acknowledged US concerns to some extent, but appeared to propose rule changes that would accommodate the very behaviour that was of concern to the US in the first place, and that would make the Appellate Body even less accountable and more susceptible to overreaching. Members did agree to launch an informal process under New Zealand's stewardship as a parallel effort to the formal discussions at the monthly meetings.

However, the stalemate over the appointment of new Appellate Body members is likely to continue. US representatives at the WTO dismissed calls to present their own reform ideas for the Body, arguing that it should simply follow existing rules. At the same time, USTR Robert Lighthizer has called the blocking of appointments to the Appellate Body the "only leverage" the US has in order to push reform at the WTO.

During his testimony at a Senate hearing on the WTO's future held on 12 March

2019, Lighthizer indicated that US obstructive behaviour in the Dispute Settlement Body or lack of consent to the appointment of new Appellate Body members could also depend on other "things". In the absence of any concrete suggestions by the US for the Appellate Body, however, it is difficult to determine what exactly it will take for the US to give up its blockage of the appointment process. On November 2019, the Trump administration also declared that it wanted to reduce its WTO membership contributions based on its grievances with Appellate Body decisions and an initiative by some WTO members to move on to jurist nominations without US consensus. Despite this bold announcement it remains hard to imagine that the US would truly be willing to dismantle a system which, according to Lighthizer, it would after all be worse off without.

How to save dispute settlement and reform WTO rules

The EU and other WTO members need to prepare for a situation in which the US continues its blockage of the Appellate Body. Even if WTO members reached agreement to replace Appellate Body members soon, it will take up to three months to actually appoint them. Given the situation, there are basically three options to consider.

Option 1: wait and support reform of the Appellate Body, on US terms

The EU and its like-minded trade partners could accept the impasse at the Appellate Body for the time being and try to engage the Trump administration in negotiations over how to reform the Appellate Body. Proposals put forward by the EU and its partners tried to address US critique of the Appellate Body, including a last minute draft General Council decision with comprehensive changes in the rules governing dispute settlement understanding tabled by New Zealand Ambassador to the WTO,

David Walker. In this draft, member states declare that the Appellate Body has not been functioning as intended under the Understanding on Rules and Procedures Governing the Settlement of Disputes (the DSU) and agree to a list of amendments addressing long-stated US demands. It includes stricter transitional rules for outgoing Appellate Body Members, application of 90-day rule for completing reports and limitations on the scope of appeals. The proposed reform, however, may not yet sufficiently address US concerns about judicial overreach. To address this issue, some experts have suggested that WTO members could decide to aim for a closer link between the dispute settlement function and the role of the WTO as a negotiating forum. If a particular interpretation of WTO rules by the Appellate Body fails to reach a consensus, it would be referred to a specialized committee. In the end, the General Council could take a final decision based on a three-quarters majority vote of all member states (so called legislative remand).

Alternatively, WTO member states could agree to put the most controversial type of Appellate Body decisions — those related to trade remedy actions like anti-dumping and countervailing actions — on hold for a limited amount of time, until a more permanent compromise can be reached with the US. Since many of the US complaints vis-à-vis the Appellate Body relate to decisions on trade remedy actions, one proposal suggested permanently separating trade remedy from other cases in the dispute settlement system, either by creating a special Appellate Body for trade remedies or by placing a moratorium on appeals from panel decisions on such cases. Such a special body could mirror the working procedures of the Appellate Body. Its members could have backgrounds in trade remedy law, ensuring sound rulings. It would split the current workload of the Appellate Body (trade remedies disputes are 45 percent of all its cases). Such a restructuring of the Appellate Body would require an amendment to the Dispute Settlement Understanding (DSU).

Both of the proposals above would require a consensus among WTO members on a fundamental restructuring of the existing appeals process. However, it is unclear whether the US would be less concerned about judicial overreach by the suggested solutions and end its blockage, or whether China would agree to any of these proposals given that they mostly aim to accommodate US concerns.

Option 2: work towards a different system for appeals inside the WTO

A more proactive approach would be for the EU to form a coalition with other WTO members to preserve the current two-stage dispute settlement process and to temporarily abandon consensus decisions. Member states, with the exception of the US, could move forward with selecting new Appellate Body members by qualified majority vote in the General Council. This way, members would depart from the regular process that requires a consensus vote in the WTO's Dispute Settlement Body. However, members could claim to be meeting their obligations (Art. 17.2 DSU "Vacancies shall be filled as they arise").

Another way to overcome the impasse would be for member states to draw on Article 25 of the DSU which allows WTO members to resort to arbitration as an alternative means of dispute settlement, the exact procedures of which would be determined by the dispute parties. Parties in a dispute could agree to arbitrate appeals before the panel issues its ruling and let the arbitration process mirror the process of appeals before the Appellate Body, e.g. by having arbitrators adopt the Working Procedures. The Appellate Body Secretariat could assist in the arbitration process and WTO rules on implementation of rulings (Art. 21 DSU) and compensation (Art. 22 DSU) would apply to any arbitration awards.

In recent bilateral agreements, the EU, Canada and Norway have pledged to accept Article 25 arbitration as binding. Since

Article 25 DSU is an existing provision, no consensus vote is needed to use it, at least as interim solution. Nevertheless, this approach has several drawbacks. One risk attached to the flexibility under Article 25 for smaller dispute parties to agree on proceedings is that powerful WTO members like China or the EU could push for rules that put them at an advantage. Less powerful members also have ways of blocking dispute settlement when they anticipate an unfavourable panel ruling. They could still refuse arbitration and block the adoption of the panel report by filing for appeal with the incapacitated Appellate Body. Those cases would remain in limbo for years to come. For all of the above reasons, there is uncertainty about how viable this solution would be in practice.

Therefore, a plurilateral arbitration agreement, binding participating countries to a specified arbitration process ahead of new disputes might be a better option. It would take more time and political capital to achieve. With the stalemate of the Appellate Body approaching, the Trump administration has been increasing political pressure on member states. In a meeting in Geneva on 13 November, the US government representative named steps by other member states away from consensus voting as a reason for current US plans to cut or even fully withdraw financial contributions to the 2020–2021 budget. Others have warned that a move to Art. 25 arbitration could even be taken as justification for President Trump to follow up on his threats to leave the WTO.

The benefits of a plurilateral agreement on Article 25 arbitration would crucially depend on China's participation. For an agreement to gain traction without US participation, it would need to include China. According to the ChinaPower Project, China was involved in 63 disputes with 9 economies from the time it acceded to the WTO in 2001 through 2018. Beijing has been the complainant 20 times and the respondent 43 times. So far, the EU has brought 35 cases against the US and nine cases against China at the WTO, including recent com-

plaints over US tariffs on European steel and aluminium, and forced technology transfer in China.

Option 3: aim for dispute settlement outside of the WTO

If no consensus on a way forward on dispute settlement can be reached within the WTO, the EU might draw on its bilateral and regional free trade agreements, like the EU-Canada agreement (CETA). However, the EU's existing bilateral and plurilateral agreements provide little, if any, legal protection in state-to-state-litigation cases beyond what is granted under WTO rules. What some of these agreements entail are rules on how to proceed in cases where private parties want to take legal steps against a government, known as Investor-State-Dispute-Settlement (ISDS)-procedures.

Due to recent agreements with Singapore and Vietnam and a preliminary agreement with the MERCOSUR countries, the share of EU external trade covered by these agreements is expected to increase beyond the 2017 status of around 30 percent to around 40 percent. Nevertheless, trade with major partners, including the US and China, which together account for roughly a third of the EU's external trade, still takes place under WTO rules. EU agreements with both countries in the near future are far from certain.

Another yet more ambitious and politically costly option for the EU would be to sound out if other countries would choose to be part of a parallel state-to-state dispute settlement system, outside of the WTO. As in the case of Art. 25 arbitration, such a move could be taken as justification for President Trump to leave the WTO. Moreover, it might alienate even those actors in the US who have criticized the Trump administration's policy towards the WTO and argued in favour of the multilateral trade order. It would make past pledges by the EU and others to do everything in their might to preserve WTO dispute settlement system look less credible.

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Outlook

The EU will have to find levers and think of the right incentives to get the US and China back to the negotiation table to preserve and reform the WTO, which would be in its own best interest. In the short run, to limit the Appellate Body impasse to a minimum, the EU can draw on arbitration procedures in its existing trade and investment agreements with other states. But a more viable solution would be for the EU and others to resort to Art. 25 arbitration inside the WTO framework, ideally by joining a plurilateral agreement. A temporary solution outside the WTO would be helpful only to handle disputes with parties who share the same interest in preserving the WTO (and ideally are connected to the EU in regional trade agreements). However, by resorting to a dispute settlement mechanism outside of the WTO, the EU risks undermining its previously stated commitment to the resolution of trade disputes at the WTO through binding two-level, independent and impartial adjudication by a Standing Appellate Body.

For a viable solution, exerting pressure on the US will be a difficult undertaking as long as the US trade policy makers are able to put considerable pressure on its major trading partners, China and the EU. One option for resolving the WTO situation should be tested with China. This, however, will come at a cost. For instance, China could request that the EU approves the Chinese WTO status as a market economy, something which Brussels has so far refused to do for largely the same reasons as the US, chief among them being grievances over heavy state intervention in the economy, subsidies, treatment of intellectual property and forced technology transfer. Beijing could also ask for an easing of investment controls and access to the EU internal market.

In any diplomatic attempts to approach the US and China, the EU Commission has to consider which way forward would limit the current and future cost to the European economy. The EU should continue to work together with other trade partners like Japan, Canada Mexico, and India — for instance by discussing long and short-term options and finding a common understanding of how to tactically approach the US government.

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