

## Defining the Future of Trade *Need for a Geneva Consensus*

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With right conditions and right policy mix, trade liberalisation can be an effective tool for poverty amelioration and reduction in income inequality leading to inclusive growth. Though this can be contested through micro studies, broadly speaking it is evident from trade liberalisation in the 20<sup>th</sup> century and its impact on economic growth and development. Given the emerging challenges in the 21<sup>st</sup> century, is it possible for the multilateral trading system under the aegis of the World Trade Organisation (WTO) to address them?

This Discussion Paper argues that it is possible provided two conditions (*strengthening of the WTO to act as an institution where diverse expectations can be harmonised and collective stability to the multilateral trading system by the new Quad of the WTO Members*) are met with a reasonable degree of success. And for this to happen, a Geneva Consensus is to be evolved for multilateralism to work better.

### Introduction & Context

Trade by its very nature enables specialisation, exploits economies of scale, and generates competition in markets. This results in efficient allocation of resources and enhancement of productivity, which are at the heart of economic progress.

Some highlights from recent studies on trade liberalisation and its impact on economic growth and development are as follows:

- A 10 percent increase in trade openness reduced unemployment by 1.0 percent for a mix of developed and developing countries (Felbermayr *et al*, 2009). Trade liberalisation may lead to immediate increase in unemployment but employment-generation effect is felt with a time lag – unemployment declines by 3.50 percent three years after liberalisation.
- In a comparative study on trade and employment generation in four countries, viz. Bangladesh, Kenya, South Africa and Vietnam, Sen (2008) found “Kenya and South Africa have been handicapped by a lack of active export promotion and the capital intensity of their exports. Asian countries have converted their export gains better into employment benefits as the composition of

their export basket has been dominated by labour intensive items, unlike the African countries. However, within the studied Asian countries, Bangladesh has stolen a march over Vietnam by further changing the composition of its export basket in favour of labour intensive products. In this way Bangladesh does offer a model for inclusive growth which might be worthy of emulation.”

- According to a CUTS International study done in 2008 on trade-development-poverty linkages in 13 developing countries, countries showed very different poverty reduction responses to growth in exports. For example, while long-term trends (from mid 1980s to the middle of the last decade) average tariffs, growth in gross domestic products and growth in exports of Kenya and Zambia were similar, average rate of poverty reduction was higher in Zambia than in Kenya. Similarly, both Vietnam and Pakistan showed good growth rates but poverty came down much faster in Vietnam as compared to Pakistan. Such differences can best be explained on the basis of presence of other factors including right policy mix and flanking policies (Mehta, 2008; Raihan & Razzaque, 2008; Razzaque & Raihan, 2008).

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While trade and investment openness is a necessary condition for sustained economic growth, other flanking factors are required for trade to play its role in realising growth and employment potential of an economy. These include:

- a plural political system and its stability;
- institutionalisation of the rule of law governing the society (not just economic laws *per se*);
- an evolving social and institutional structure for mainstreaming trade into development;
- sound macroeconomic policies and their stability;
- a comprehensive and coherent policy framework; and
- effective regulatory reforms, including consumer welfare regimes.

As the history of economic development and the recent economic crisis and its aftermath demonstrate, holistic policy-making approach is crucial. The best of trade policies will not have the desired impact on growth and employment if they are not formulated and implemented in conjunction with:

- suitable monetary policy (e.g. adequate credit and money supply and exchange rate stability);
- balanced fiscal policy (e.g. appropriate tax system and public funding of physical and social infrastructure);
- development-oriented investment policy (e.g. facilitate flow of foreign investment with technology and services inputs); and
- effective competition policy (e.g. to deal with anticompetitive practices, and market and regulatory failures to ensure that the benefits of trade liberalisation reach the producers and consumers).

Can trade liberalisation be an effective tool for inclusive growth and poverty amelioration? A simple answer is yes if trade liberalisation is complemented with adjustment assistance and social safety nets to facilitate movement of workers, entrepreneurs and firms into sectors with growing demand and through access to new technologies and knowledge.

In other words, trade policy can be made an effective tool to achieve, sustain and improve the conditions necessary for a country's inclusive growth and poverty amelioration efforts (Bhagwati & Ramaswami, 1963; Hoekman, 2012). "Inclusive growth" can be defined as a long-term and sustained growth in productivity and employment opportunities for a wide range of households and firms, accompanied by public goods such as infrastructure, water, roads, healthcare and education.

Winters (2000) argued to explore the static effects of trade policy on poverty via four broad groups of institutions: enterprises, distribution channels,

government and households." According to him: "Perhaps the most direct effect of trade reform on poverty is via prices of goods/services in which poor households have large net positions. The largest price shocks occur when either the initial or final price is finite and the other infinite (i.e. when there is no market). A shock that completely undermines an important market – e.g. for a cash crop or a form of labour – is likely to have major poverty implications. Similarly, bringing new opportunities, goods or services to the poor can greatly enhance welfare."

The issue is: how to improve the terms of trade of those products with which poor are associated with, such as in the area of labour intensive products, and how to adjust/insulate them from trade-related shocks?

A related issue is the impact of trade liberalisation on income inequality. Goldberg and Pavcnik (2004) examined empirical evidence on the relationship between trade liberalisation, income inequality and poverty in developing countries and found that "there is little evidence that trade reforms are associated with an increase in informal employment and a worsening of working conditions. To the extent that one finds such evidence, it seems to be relevant in settings characterised by severe labour market rigidities. A study of labour market institutions and their interactions with trade policy is therefore essential for understanding the effects of trade liberalisation on inequality and poverty".

In short, trade opening can be made an effective means for poverty amelioration and reduction in income inequality leading to inclusive growth provided there is the right policy mix and the rules of the game for cross-border trade facilitation are well-defined and adhered to.

Keeping in mind the objective of poverty amelioration and reduction in income inequality through trade opening, the WTO Director General, Pascal Lamy, has constituted a high level panel of stakeholders for "Defining the Future of Trade". (Pradeep S. Mehta, Secretary General, CUTS International is a member of this panel.)

The Panel's goals are not to deliberate on the Doha Round of multilateral trade negotiations or the institutional aspects of the WTO, but to build a scenario for the 21<sup>st</sup> century.

This Discussion Paper argues that the Future of Trade should be looked at by taking into account the following factors:

- WTO should be made more effective in playing its core functions of governance of the multilateral trading system; and
- Trade in goods and services are fast evolving into trade in tasks – how to create conditions necessary for poor countries to get engaged with trade in tasks.

It concludes with an outline of 21<sup>st</sup> century trade challenges along with some suggestions for a forward-looking agenda to create conditions necessary – an enabling environment – for poor countries to lift them out of poverty. The Paper discusses some evolving economic scenarios and 21<sup>st</sup> century trade challenges and concludes with a non-exhaustive agenda to address them.

### **Evolving Economic Scenarios**

Global economy continues to evolve and sometimes in a manner which is not easy to predict. However, some key drivers of this evolution should be identified and their potential impact – both opportunities and challenges on international trade and development of developing countries – should be assessed.

#### **Changing Economic Geography**

The rise of the emerging South has fundamentally changed the post-Cold War global economic geography. Their contribution to global gross domestic product, trade and investment flows, development assistance, and ultimately to innovation and technology development is substantial. The large size of their populations and poverty incidence also means that they will need to, and may very well continue to grow at a faster pace than the Organisation for Economic Cooperation and Development countries.

The emerging South also provides alternative and growing markets to other developing countries as well as lessons for inclusive growth. Their need for growth *per se* and inclusive growth are to be recognised for multilateralism to be more effective. Between 2000 and 2010, the combined share of the EU and the US in world trade declined by about 7.0 percent, while the combined share of Brazil, China and India increased by about the same percentage (calculated from ITC Trade Map).

Rise of the emerging South should be used to expand and diversify trade and development opportunities of other countries including through effective implementation of trilateral development cooperation initiatives among the Northern/Southern donors, Southern recipients and Southern implementers and particularly recognising the importance of “knowledge” as the third critical factor of production (the other two being capital and labour).

#### **Preferential Trade Agreements**

There exist a broad range of preferential trade agreements (PTAs) among countries, which include bilateral, sub-regional, regional, inter-regional, free trade agreement, customs union, economic integration, etc. Subjects covered range from traditional trade in goods to trade in services to free

movement of people and finance, etc. Over the last couple of decades, their growth in number and coverage has been particularly intense.

PTAs pose many challenges and some of them are:

- development of rules on new issues and deeper disciplines on issues covered by the WTO (WTO-plus agreements) that can set precedents for later WTO rules may not necessarily be good for development (e.g. IP protection, investor-state dispute settlement);
- diverting attention and resources including negotiating capital from multilateral trading system;
- creating a web of overlapping and inconsistent trade rules; and
- marginalising smaller developing countries in the rules-making process and their implementation.

#### **Global Supply/Value Chains**

Innovation-production-marketing networks are now dispersed across firms and countries. This is changing the traditional manner of categorising international trade from silos of “trade in goods” and “trade in services” to “trade in tasks”. This has led to:

- greater fragmentation of markets;
- lengthening of supply chains; and
- growing trade in intermediate parts and components.

Participation in global supply/value chains, particularly in higher value-added tasks, can provide opportunities to developing countries to make trade an effective means for inclusive growth. However, most poor countries specialise in producing commodities in which fragmentation is less feasible.

Global supply/value chains present two main challenges to the international trading system. First relates to the need to re-think trade flows and their origins as trade in tasks with incremental values being added at each stage, located in different countries. This re-thinking can fundamentally alter the content and dynamics of international trade negotiations as conventional concept of trade surplus/deficit will get challenged and become redundant over time.

Secondly, trade will increasingly occur under imperfect competition with increasing returns to scale and trade cannot achieve first-best outcomes in the presence of distortions, particularly on account of non-tariff measures (Bhagwati, 1987).

Given these challenges of trade in tasks, what would be the impact of likely deterioration in terms of trade of less-manufactured products in causing depreciation of exchange rates of countries specialising in producing them and their impact on current account?

## 21<sup>st</sup> Century Trade Challenges

With right conditions and right policy mix trade opening can be made an effective tool for poverty amelioration and reduction in income inequality. Though this can be contested through micro level studies, broadly speaking this is evident from both analytical and empirical literature on trade liberalisation in the 20<sup>th</sup> century and its impact on economic growth and development.

At the same time, it is also true that 21<sup>st</sup> century trade challenges are different from those in the past. While international trade is fast evolving from trade in goods and services to trade in tasks, the following are two most important 21<sup>st</sup> century trade challenges:

- Non-tariff measures impacting countries' ability to conduct trade in tasks, particularly under imperfect competition (increasing returns to scale of factors of production); and
- Linkages between trade and trade-related issues in governing global public goods such as climate change, food security. Not "climate change", "food security" *per se* but in terms of their impact on consumption, standards of living, etc.

Is the multilateral trading system under the aegis of the WTO (as a core of the governance of multilateral trading system) ready to face these challenges?

These challenges are to be addressed in the light of the Preamble Establishing the WTO:

*"Recognising that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment (emphasis supplied) and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing for the optimal use of the world's resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development."*

It also needs to be understood that sustainable development is not only about environment protection but also economic and social advancement simultaneously.

This question (whether the multilateral trading system is ready to face 21<sup>st</sup> century trade challenges) is to be addressed in the light of the following two conditions:

- WTO, as an institution, *acts* as a platform where diverse expectations are harmonised
- The new Quad of the WTO Members, consisting of Brazil, the EU, India and the US, along with China, collectively *provides* stability to the multilateral trading system

The first one fundamentally deals with the *purpose* of the WTO as an institution. For the multilateral trading system to work better, there should be more emphasis on reciprocal obligations including "less than full reciprocity" on the part of all of its players as per "common but differentiated responsibilities" for trade liberalisation to act as an effective means for poverty amelioration and reduction in inequality leading to inclusive growth. Countries should focus on absolute gains that would accrue to them as a result of taking part in the multilateral trading system as against relative gains.

Wilkinson (2012) argues: "... we must return to that least asked, but most pressing of questions: what is the point of the WTO? If we ask ourselves that question and come up with an answer which says that we want a system that consistently delivers unbalanced trade deals favouring the richer industrial states over their poorer, less able developing counterparts and which has become increasingly moribund, then let us fiddle round the edges and leave the institution largely as it is.

However, if we come up with an answer that says the WTO should generate trade-led growth for all (something that we all ought to be able to agree on), then we need to redesign it as such, getting rid of competitive negotiating as a mechanism for delivering 'gains' and accept that in facilitating trade-led growth for all it will inevitably become a development institution (and we should accept that it is one)."

The debate should not be about describing the WTO a supranational body resulting in multilateralisation of sovereignty. There should be a debate on how to strengthen the WTO as an institution to deliver trade as an important tool for inclusive growth. 21<sup>st</sup> century trade challenges should be addressed in respect to opportunities and concerns emanating from them to impact inclusive growth. They should be looked at through countries' ability to reciprocate. Technical assistance for capacity building of poor countries should be assessed in terms of improving their ability to reciprocate and participate with confidence in the system.

Secondly, for the WTO to become a more effective institution to deliver trade as an important tool for inclusive growth, there should be stability in the system. The new Quad should be responsible for collectively providing stability to the WTO as an institution governing the multilateral trading system.

21<sup>st</sup> century trade challenges are such that in order to address them there should be less conflict in governing the multilateral trading system. Collective leadership can provide much-needed stability in the multilateral trading system by both reducing the possibilities of conflicts among the WTO Members and their ability to reduce conflicts through the use of

economic power (Kindleberger, 1973; Hubbard, 2010). They should exercise their economic power collectively and through economic diplomacy as against coercion.

Here, it is important to note that collective leadership of the new Quad does not mean that other WTO Members will be subjects of their economic and diplomatic power. Power relations between the WTO Members and the WTO as an institution should undergo necessary changes so that there is “triadic relations” between the WTO as an institution, collective leadership and other WTO Members. In other words, the WTO Secretariat should not be a “missing middle” between the collective leadership and other WTO Members but should act as an effective institution to set norms and rules of interaction between and among its members.

Given the two conditions which can determine whether 21<sup>st</sup> century trade challenges can be successfully addressed or not (in other words, effectiveness of the multilateral trading system), there are four possible scenarios:

- An ideal scenario is where there is a high degree of possibility of the fulfillment of both the conditions – the WTO, as an institution, *acts* as a platform where diverse expectations can be harmonised and collectively the new Quad of the WTO Members *provides* stability to the multilateral trading system.
- The most undesirable scenario is where none of the two conditions are fulfilled. That could lead the world to an economic chaos as witnessed during the inter-war years in early part of the 20<sup>th</sup> century. The impending economic crisis in Eurozone countries may prove to be more than just some flapping of butterfly wings.
- The other two scenarios (combination of the two conditions) are unlikely to happen. This is because the two conditions necessary for addressing 21<sup>st</sup> century trade challenges are to be looked at as per the principles of normative economics as against those of positive economics. In other words, 21<sup>st</sup> century trade challenges should be addressed by not considering them what they are but with respect to what they ought to be.

The WTO Secretariat should be empowered by its Members so that it can live up to its *purpose*, as stated in the Preamble Establishing the WTO, by persuading the WTO Members to create an enabling environment for the fulfillment of these two conditions.

Assuming that the two conditions will be fulfilled with a reasonable degree of success, a non-exhaustive agenda to address 21<sup>st</sup> century trade challenges is as follows:

- Trade policies of countries should be reviewed in respect to their ability to fulfill the role of trade as an effective means for poverty amelioration and reduction in income inequality leading to inclusive growth – in other words, the relationship between trade and consumer welfare (as described in the Preamble Establishing the WTO) should be the guiding principle of reviewing trade policies.
- The impact of non-tariff measures on trade under imperfect competition should be studied so as to negotiate multilaterally-agreed rules, including quantification of non-tariff measures and their gradual reduction on the basis of countries’ ability to reciprocate, to reduce their scope to distort trade.
- Trade in tasks cannot be performed well unless there is equal emphasis on all three factors of production – capital, labour and knowledge – as their use is increasingly getting integrated, in some sense they are endogenous as well. While trade in capital and that in knowledge is drawing political attention among the policy-makers, that is not so in case of trade in labour. More emphasis on addressing labour market rigidities through trade in labour will not only strengthen the role of trade as a tool for inclusive growth but will also help poor countries to get integrated with global efforts on trade in tasks.
- Based on the principles of reciprocity and non-discrimination, there should be multilaterally-agreed rules to address trade-related market-contestability issues arising as a result of competition-related trade distortions and trade-related competition distortions.
- The WTO Secretariat should do joint studies with United Nations Framework Convention on Climate Change, Food and Agriculture Organisation and other inter-governmental organisations to understand trade and trade-related issues in governing global public goods such as climate change, food security and how the poor countries can deal with them.

Neither the multilateral trading system nor its core – the WTO – talks about free trade. Drawing from the relevant literature on international trade the WTO Secretariat should commission studies on the above-stated agenda to find out under what conditions violations of free trade principles can lead to optimal policy outcomes.

Accordingly, there should be a new set of multilateral rules for utilising international trade as an important tool for inclusive growth. Opportunity costs of doing trade in tasks should be looked at both in positive and normative sense.

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