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Debate

A Fragmenting Global Economy: A Weakened WTO, Mega FTAs, and Murky Protectionism

VINOD K. AGGARWAL AND SIMON J. EVENETT
University of California, Berkeley and Chung-Ang University
St Gallen University

Introduction

Since the onset of the recent global financial crisis, the threats to the non-discriminatory roots of the world trading system, long a key element of the liberal global order, have grown in prominence and risk becoming entrenched. Governments have repeatedly circumvented Most Favored Nation and National Treatment principles as they sought advantage for domestic commercial interests during an era where postwar assumptions about global economic governance are increasingly questioned and in the panic following the global financial crisis.

As the last decade wore on, no basis was found to conclude the Doha Round at the World Trade Organization (WTO), substantially weakening this body's standing in the eyes of prime ministers and presidents. Meanwhile, the years since 1995 have witnessed a rapid rise in the negotiation of Free Trade Agreements (FTAs), both by major powers such as the U.S., EU, China, and India, as well as by smaller and medium-sized economies. More recently, initiatives to create several so-called mega FTAs were launched, including the Trans-Pacific Partnership (TPP), a Transatlantic Trade and Investment Partnership (TTIP), and a Regional Comprehensive Economic Partnership (RCEP) in the Asia-Pacific. Finally, the crisis-era has seen extensive resort to less transparent—so-called murkier—forms of protectionism and a resurgence of interest in selective government intervention, or industrial policy.[1]

After detailing these trends, this article identifies and explains the underlying causes. Our conclusion is that governments are now accelerating the process of fragmentation that had been underway for some time. What the recent economic crisis did was to make governments desperate to advance domestic commercial interests, all too often at the expense of foreign rivals.

The proliferation of FTAs and the prospect of more mega-FTAs

In the 19th century and well into the 20th century, bilateral FTAs were the primary form of trade liberalization, along with certain high-profile unilateral trade reforms. With the creation of the General Agreement on Tariffs and Trade in 1947, governments added a

[1] For an overview of the facts about the former see Evenett (2013a); for the latter, see Aggarwal and Evenett (2012).

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multilateral string to their liberalizing bow. With the notable exception of Europe, from 1945 until the early 1990s FTAs did not become entrenched elsewhere. For sure, many developing countries signed FTAs during the 1960s but they soon lapsed. For the most part, the pendulum had swung towards multilateral trade reform. This changed in the early 1990s.

In 1994, there were only 47 FTAs in effect. By 2000, this number had risen to 93, and it then shot up to 260 by 2013.[2] The EU pursued a number of other accords in the 1990s but, so as to focus on the Doha Round, between 2000 and 2006 it undertook a self-imposed moratorium on launching new FTAs. The EU has now concluded agreements with several countries, and is in negotiation with India, the U.S., and Japan, among others.

For its part, the U.S. did not pursue any FTAs until 1985, when it signed a foreign policy-motivated accord with Israel. Following that agreement, it concluded an agreement with Canada in 1987 and NAFTA in 1994. Beginning in 2000, as part of a "Competitive Liberalization" strategy it has inked accords with many small countries, partly for security reasons (Aggarwal 2013), as well as with South Korea.

Other larger trading nations including China, Japan, Korea, as well as smaller countries, such as Chile and Singapore, have been particularly active in negotiating FTAs. Several smaller states have sought to become "hubs" in their regions to boost trade and attract foreign direct investment. In the Asia-Pacific, there has been a rapid proliferation of FTAs, particularly in the 2000s, often with differing provisions and exclusions. This has led to calls for rationalization of the resulting "noodle bowl" of RTAs that is being created and provided one of the motives for negotiating "mega" FTAs.

From APEC to TPP

Despite significant non-binding, peer pressure-based efforts to promote open trade across the region, the Asia Pacific Economic Cooperation (APEC) initiative faltered despite claims that industrialized countries had met the Bogor Goals. Subsequently, the U.S. and others have sought to revitalize APEC in various ways, most prominently through it as a vehicle to create a Free Trade Area of the Asia Pacific (FTAAP) and, more recently, to negotiate the TPP. The U.S. shifted its position to support FTAAP in 2006, an idea in which it had previously shown little interest despite enthusiastic support from the APEC Business Advisory Council. Shortly before that year's APEC summit, President Bush endorsed the idea of an FTAAP in a speech in Singapore.

Given APEC's lack of an institutional mechanism to negotiate trade agreements, as well as its large membership of 21 economies, efforts to promote FTAAP faced strong headwinds. In 2008, the Bush Administration changed tack, signaling its intent in September to become part of the P4, which has evolved into the TPP.[3] Although momentum behind the latter was lost as the financial crisis intensified, President Obama decided in November 2009 to pursue TPP for the reasons given below as well as to expand exports to a region that held still out significant growth prospects.

Several secular factors influenced the Obama Administration's decision to pursue TPP. First was the proliferation of a diverse set of FTAs affecting US business, with differences

[2] Data from WTO website. There is a discrepancy between the WTO database and the text on its website which list 250 RTAs in 2013. We have used the actual database.

[3] The original P4 agreement, brought together Chile, New Zealand, Singapore and Brunei, included the goal of encouraging others in the Asia-Pacific to join as well.

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in scope, architecture, objectives, and standards imposing transaction costs (Capling and Ravenhill 2011, 556). Second, a bottom-up approach to deeper integration could limit the harm to import-competing groups because the countries involved initially in the TPP were already relatively open and small. Third, the U.S. has emphasized TPP for security reasons, in view of its "pivot" toward Asia. As then-Secretary of State Hillary Clinton (2011) wrote:

> In Asia, they ask whether we are really there to stay, whether we are likely to be distracted again by events elsewhere, whether we can make—and keep—credible economic and strategic commitments, and whether we can back those commitments with action. The answer is: "We can, and we will."

American efforts to re-engage with Asia have been supported by its allies. Singapore's former Prime Minister Lee Kuan Yew has warned of increasing Chinese dominance and diminishing American relevance should the U.S. appear to disengage from the Asia-Pacific (Bergsten and Schott 2010).

Lastly, negotiating TPP gives U.S. officials the opportunity to continue pushing for selective standards on labor, environment, and intellectual property, made easier in view of the like-minded states involved and their relatively small size that facilitates such issue linkage.

Still, TPP completion faces obstacles. As of October 2013, outstanding issues include differences in intellectual property regimes (particularly in the pharmaceutical industry), in policies towards green industries and the environment, to approaches to state-owned enterprises, and to creating market access without exceptions (*Inside U.S. Trade*, October 11, 2013). For Japan, agriculture has been of great sensitivity, but it would appear that it is now considering allowing access in the previously untouchable products of rice, wheat, beef, pork, diary, and sugar. Achieving the goal of eliminating tariffs on all products might then be possible—albeit in recent discussions with a 30 year phase-out period for the most sensitive goods (*Japan Times News*, October 9, 2003).

Yet while domestic opposition to TPP exists in the U.S. and other countries, negotiations are reportedly near conclusion after the nineteenth round took place in Brunei. It remains to be seen if a final agreement can be initialed by the end of 2013, the goal of the Obama Administration.

From ASEAN plus 3 to RCEP

In Asia, ASEAN has long attempted to drive region-wide trade liberalization. In 1996, in response to EU interest in deepening economic relations with Asia that led to the creation of ASEM (Asian Europe Meeting in 1996), ASEAN, Japan, Korea, and China coordinated their positions, leading to what is known as APT (ASEAN plus three). Over time, in the wake of ASEAN FTAs with China, Japan, Korea, and India, interest grew in creating a broader grouping, known as ASEAN plus 6 with the addition of Australia, India, and New Zealand.

With the U.S. promoting TPP as the principal liberalizing vehicle in the Asia-Pacific, China acceded to Japan's proposal to focus on ASEAN plus 6 initiative, rather ASEAN plus 3. The idea of creating RCEP was first floated in February 2012 at the ASEAN Economic Ministers Retreat, and later formalized the following November at the East Asian Summit held in Cambodia. Brunei hosted the first round of negotiations in May 2013 where officials established working groups on the three issues they hoped to address: trade in goods, trade in services, and cross-border investment. At this point, negotiations are slated to conclude by 2015. As opposed to TPP, which bills itself as a "gold standard," uniform agreement with few exceptions for individual countries, RCEP is considerably more accommodating and focuses on traditional trade policies, rather than the host of behind-the-border issues being broached in TPP.

TTIP

Even though proposals for transatlantic trade reform go back at least 25 years, negotiations were only formally launched in June 2013. Despite Congressional reservations, the US was willing to try again. Northern liberal trading nations in the EU, including the UK, had long wanted formal talks to begin. What was decisive was the active support of Berlin. Here the Eurozone crisis appears to have been crucial. German industry and officialdom has sought to reduce its export exposure to slow-growing EU markets, in particular the crisis-ridden periphery. In addition to promoting transatlantic trade reform, Berlin has improved commercial relations with the fast-growing emerging markets. Even though economists rarely argue that FTAs have major employment effects, political leaders on both sides of the Atlantic promoted the talks on the grounds that the jobs created would be welcome at a time of high unemployment. Interestingly, addressing crisis-era protectionism was not a publicly-stated goal of these talks, or the TPP for that matter.

While TPP involves one leading trading power[4] seeking to spread its ideas for trade rules to a collection of smaller industrialised and developing economies, the TTIP negotiations involve two parties with their own sets of entrenched and advanced regulatory structures. Over the years those structures have assumed greater importance in transatlantic trade disputes.

Outside of the important area of opening up public procurement contracts to foreign competition, the objectives of this negotiation relate more to regulatory alignment than to market access. TTIP isn't likely to cut a swathe through agricultural protectionism and subsidies on either side of the Atlantic, although the dictates of legislative ratification will require some token opening for selected farm products. Given the already low levels of tariffs on manufactured imports, TTIP's potential for integrating markets through traditional trade reforms is limited.

Given our theme of fragmentation, the TTIP negotiations will be interesting for they will reveal the extent to which firms, having invested and restructured their operations around existing domestic regulations, are willing to allow foreign rivals to have better access to their home markets without making similar outlays. The adoption of mutual recognition principles not only expands commercial opportunities in trading partners, they increase competition at home—the latter being unwelcome to many incumbents. Negotiators know this and have emphasized the alignment of future regulations, as if this markedly changes the commercial calculus. As an initiative to limit fragmentation, TTIP is likely to fall short.[5]

Murky protectionism: Beggaring-thy-neighbour during the Great Recession

Since the onset of the global financial crisis, one of the most tangible manifestations of the growing fragmentation of the global economy is the resort by governments to a diverse range of protectionist policy instruments. Here fragmentation should be taken to mean

[4] Japan has played a much diminished role in trade circles since the conclusion of the Uruguay Round.

[5] This is in addition to the worries of some that TTIP's implementation could harm third parties (Mattoo 2013).

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departures from nationality-blind treatment of commercial interests that creates differences across rivals in the profitability of serving the same customers.

This notion of fragmentation applies not just to trade in goods but to trade in services and to commercial activities associated with cross-border movements of physical investments, intellectual property rights, and personnel—all of which are important features of the global business landscape in the 21st century.

Once one accepts a broad notion of fragmentation—and with it a broader range of the policy instruments associated with protectionism that cause that fragmentation—then it is necessary to shed some of the notions associated with protectionism in the past. The collapse of world trade in the 1930s was associated with (but certainly not entirely caused by) rising tariffs barriers and the imposition of import quotas (Irwin 2012). Applying this historical lens is misleading in contemporary circumstances (Evenett 2013b).

Perhaps one reason why protectionism is still associated with trade restrictions is that only during the past five years has much more data on other forms of beggar-thy-neighbour policies become available. A substantial data collection effort, resulting in nearly 4,000 state measures being documented by the time of this writing, has been undertaken by the Global Trade Alert team of independent trade policy analysts.[6] Resources to extend that data collection to before the crisis have not been available. The inability to conduct every type of inter-temporal analysis is unfortunate—but the perfect should not be made the enemy of the good.

One key finding about contemporary crisis-era protectionism is that less than half of it involves the traditional trade policy instruments of tariff increases and measures against dumped and subsidised imports and against import surges. That is, there has been considerable resort to other, less transparent or murkier forms of protectionism. Another finding is the fact that bailouts, export subsidies, and other incentives to export account for at least a third of all beggar-thy-neighbour measures imposed worldwide. Trade theory has long recognised that subsidies can distort trade flows, shifting sales and profits to domestic firms.[7] Policies don't have to slash trade to distort it, misallocate resources, and reduce living standards—points lost in many commentaries on contemporary protectionism.

The targeting of specific firms and sectors, often referred to as industrial policy, is a common feature of crisis-era policy response in the biggest trading powers (see Aggarwal and Evenett 2012 for evidence). Research underway suggests that the use of performance requirements—such as rules to buy local content—represent a significant feature of emerging market crisis-era policy response. Moreover, only 14 per cent of beggar-thy-neighbour measures imposed since November 2008 have lapsed.[8]

That so much contemporary protectionism does not involve tariffs and trade defence instruments suggests that governments have circumvented the tougher multilateral trade disciplines on traditional forms of protectionism. WTO rules have probably done more to alter the composition of crisis-era protectionism than restrain it. Moreover, what limited disciplines on murkier forms of protectionism exist were further undermined by the setup

[6] In the interests of full disclosure Simon Evenett is the coordinator of the Global Trade Alert. The landscape of global protectionism, in particular the G20's contribution to it, are described in the latest report of the Global Trade Alert (Evenett 2013a).

[7] The last burst of research into the impact of subsidies and the like on trade flows and competition between firms in international markets was in the 1980s. One doesn't have to subscribe to all of the normative implications of strategic trade policy to appreciate its positive implications for the impact of financial incentives on international commerce.

[8] Data extracted from the Advanced Search page of the Global Trade Alert website on 21 October 2013.

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for WTO disputes, which can only be initiated by one member against another. A systemic economic crisis creates simultaneous pressures to discriminate against foreign commercial interests and since "people who live in glass houses don't throw stones," it is noteworthy that the number of dispute settlement cases brought during 2007-11 was below the pre-crisis trend. So much for the jewel in the WTO's crown, as some characterise the WTO's Dispute Settlement Understanding.

The root causes of fragmentation

Four factors, brought to a head and amplified during the frenzied policymaking of the crisis-era, underpin the growing fragmentation of the world economy. The first two account for the WTO ceasing to roll back fragmentation. The third to a vehicle often associated with fragmentation and the fourth to the battle for ideas concerning the efficacy of fragmentation.

First, developing countries believe that they got a bad deal in the Uruguay Round. If they are to conclude further deals at the WTO, these countries want the terms to change. Yet at the same time, none wants to lose the protections afforded by WTO membership, so no developing country is prepared to leave.

Second, the rapid economic growth of the large emerging markets means that there are now forceful advocates of the developing country position at the WTO and cannot so easily be pressured, marginalized, or ignored by the richer members. The result has been an impasse in the Doha Round negotiations, a negotiation that some developing countries (like India) openly opposed the launch of and others reluctantly acquiesced to.

Third, in view of the deadlock at the WTO, the U.S. and EU have come to believe that mega-FTAs provide a better vehicle to advance their commercial interests, at least in the short to medium term. These deals may also address the creation of a noodle bowl[9] created by the proliferation of FTAs and entrench regulatory rules in as many trading partners as possible. While there is talk of eventually rolling up FTAs into a global deal, the basis of any future multilateral deal is unclear. Many developing countries, wanting a seat at the table and hedging their economic and geopolitical bets, are willing to sign demanding FTAs with the EU and U.S., in so doing discriminating against other trading partners.

Fourth, the accelerated rates of economic growth seen during the past decade in China and other emerging markets contrasted with the crisis-ridden Anglo Saxon economies has, for many, cast in a different light the calculus concerning government intervention and industrial policy, in particular. Combined with the crisis-era rush to bail out firms in many sectors of the economy, plus the evident lack of WTO discipline on murkier forms of protectionism, the proponents of a level commercial playing field have been on the defensive in the decision-making circles that matter. The crisis-era revealed the little apparent impact on national commercial policymaking of WTO accords, existing RTAs, or G20 pledges. The boundaries have been tested and found wanting. That lesson has not been lost on activist policymakers, corporate executives, and all manner of lobbyists.

Concluding remarks: Towards more fragmentation?

Is further and further fragmentation inevitable? The devil will be in the details of any mega-FTA deals that are concluded. As the world economy recovers, the process of

[9] Spaghetti bowl is the term often used in European and U.S. literature.

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unwinding recent protectionism may accelerate—but like previous protectionist spurts, it may take decades. Even if the pressures for fragmentation relent, it is far from clear that the world economy will return to the 1995 high watermark concerning non-discrimination. Indeed, just as the WTO came into force, free trade agreement-driven fragmentation picked up.[10]

One way to approach the likelihood of further fragmentation is to ask: Why is it in the interests for the big players to refrain from discrimination? What do they get in return? And which of their trading partners are prepared to pay that price? Essentially, the previous deal underlying multilateral trade accords has broken down. In that deal the U.S. and the EU limited their discrimination against smaller trading partners in return for the latter adhering to common rules and accepting market opening on terms agreed among big players.

Given the experience during the recent global economic crisis, whereby governments have routinely circumvented tougher WTO rules and in which the "glass house syndrome" has exposed the deficiencies of WTO dispute settlement, any new *modus vivendi* at the multilateral level that stands a chance of discouraging further fragmentation would have to be far-reaching, both in terms of government policies covered and institutional reforms. Optimists should ponder what circumstances will bring into alignment the interests of the EU, US, and leading emerging market members of the WTO behind such a comprehensive deal—and the likelihood of this taking place.

It would be wrong to associate a more fragmented global economy with a collapse of world trade and the protectionism of the 1930s. Given the resort to financial incentives, local content requirements, "buy national" public purchasing provisions and the like, the increasingly fragmented world economy may represent a bastardized form of globalisation riddled with massive resource misallocation, while the paucity of traditional trade barriers presents the veneer of "open borders."

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[10] Should unilateral trade reforms continue in developing countries then this is a welcome, if localised, force countering fragmentation.

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Vinod K. Aggarwal is Professor at the University of California at Berkeley, with appointments in the Travers Department of Political Science and the Haas School of Business. He also serves as Global Scholar at Chung-Ang University. Prof. Aggarwal directs the Berkeley Asia Pacific Economic Cooperation Study Center (BASC) and is Editor-in-Chief of the journal Business and Politics. He has published over 100 articles and book chapters, and is the author or editor of 20 books. His most recent book is Linking Trade and Security: Evolving Institutions and Strategies in Asia, Europe, and the United States (Springer). *Address for correspondence*: Director, Berkeley APEC Study Center, 802 Barrows Hall #1970, University of California, Berkeley, CA 94720-1970, USA. Phone: +510 642 2817; Fax: 510 643 1746; Email: vinod@berkeley.edu

Simon Evenett is Professor of International Trade and Economic Development at the University of St. Gallen, Switzerland, and co-director of the most established group of trade economists in Europe.

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