MACRO STRATEGY

Trade Uncoupling

February 2020

Key Takeaways

- The future of trade would likely be in services and digital products of all types, with goods trade and supply chains diminishing in importance.
- Uncertainties are likely to remain until challenging issues—intellectual property, dispute settlement, digital services trade in particular—are addressed.
- Risks for major trade-related flare-ups are somewhat lower in this election year.
- The election is likely to determine how the U.S. engages on trade over the next few years.

The nature of trade is changing. Global power dynamics have shifted. The range of trade topics negotiated has expanded in both number and complexity. And incentives for mutually agreeable, multinational trade agreements appear to have weakened. A historical preference for broad free trade expansion appears to be giving way to a focus on limited bilateral agreements that are narrow in focus. Whether these bilateral agreements will be leveraged for broader adoption or confined to bilaterally-negotiated trade deals remains to be seen.

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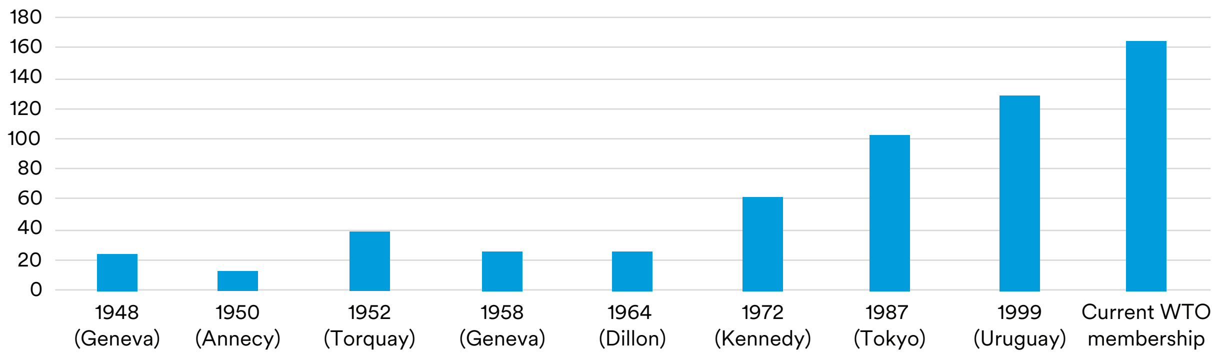
The Status Quo

Historical trade relations have been governed by the post-WWII multilateral order established by the U.S. and its allies. This order is seen as having contributed significantly to the peace and prosperity of the rest of the 20th century.[1]

The formation of multilateral institutions in the post-WWII era, among them the General Agreement on Tariffs and Trade (GATT) with 23 signatory countries, set the tone for the following decades. This grew to 128 by 1999 when the World Trade Organization (WTO) was established as the successor body to GATT.[2] (See Chart 1) The WTO had a substantially expanded remit, including agreements on services, intellectual property, and dispute settlement.

Number of signatories, by negotiation round



Source: USITC, WTO.org, as of February 18, 2020

In addition to the geopolitical benefits of closer ties among countries, there are economic benefits. Economists generally view lowering trade barriers as economically beneficial for the countries involved.[3] Lower trade barriers meant that countries were able to specialize in industries and tasks they were good at. That generally meant greater productivity for firms and lower prices for consumers.

Unconscious Uncoupling: Cracks in the Structure

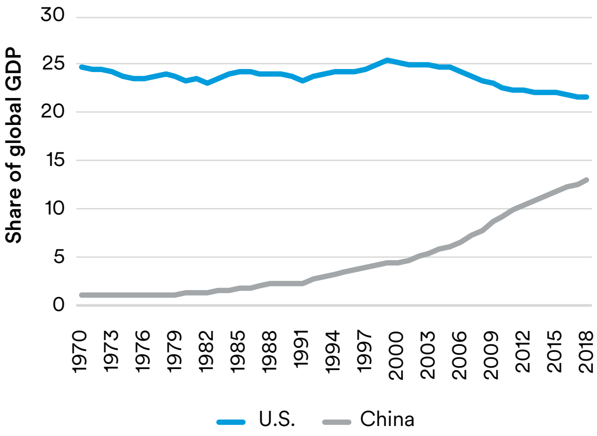
Over time, some cracks in this world order have begun to form.

The WTO has become a victim of its own success. Over the past 20 years the multilateral trade negotiation process has become unwieldy. The last completed round of negotiations, the Uruguay Round in 1999, took 8 years. The most recent round of negotiations started in 2001 in Doha but was never completed. Membership has grown since then, and the WTO today has 164 member countries. A culturally and economically diverse membership has meant greater difficulty in coming to agreement.

In addition, the WTO has successfully lowered tariffs to the point that most low hanging fruit has been picked. Now negotiators are left with the harder questions: tariffs on foodstuffs, which tend to be politically sensitive, and nontariff measures, which can encroach on sovereignty.[4] For example, harmonization of standards for sunscreens between the U.S. and the EU could reduce the complexity of serving the two markets, but any harmonization would mean compromise by one or both sides to either change its regulations or permit the import of foreign-regulated sunscreens.

On the economic front, the U.S. is no longer quite as dominant as it once was (Chart 2). More broadly, as the global economy has gotten larger, the relative share of the core developed (DM) countries – western Europe, Japan, and the U.S.—has declined. Developing countries – China and other Asian economies in particular—are emerging with their own, sometimes different, goals. International norms about the strength of intellectual property rights and state involvement are being challenged. Moreover, developed economies' tastes no longer dominate. Consumption from DM makes up about 62% of global consumption, down from 81% in 1995, and is projected to decline further, to just under 50% by 2030.[5]

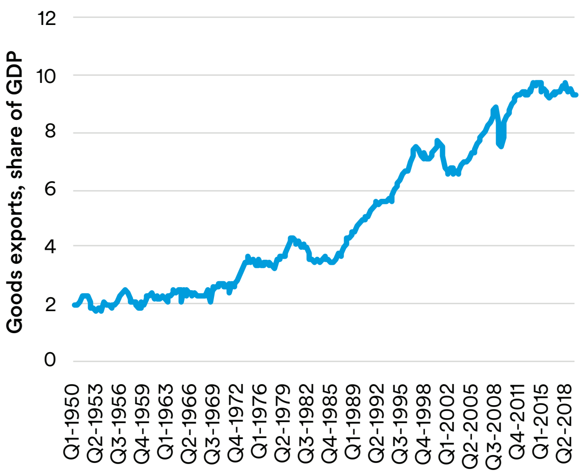
U.S. share of global GDP is falling



Source: World Bank, World Development Indicators

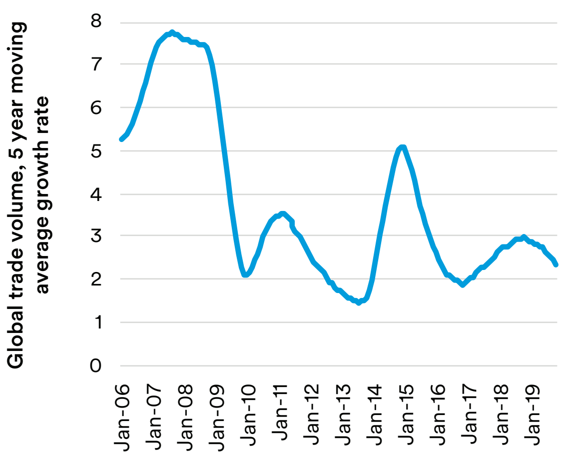
The nature of trade is also fundamentally changing. Physical goods trade, and the supply chains that produce them, have become relatively less important. U.S. goods exports as a share of GDP has flattened out at nine percent. Global trade volume growth has declined. Digital services now often replace physical goods—think streaming movies, audio books and music rather than DVDs, books and CDs. Also, the continued demand for just-in-time products has led companies to establish production closer to their customers, leading to foreign investment rather than trade.[6]

U.S. goods exports plateauing



Source: BEA/Haver, MIM

Global trade volume growth is decelerating



Source: CPB Netherlands World Trade Monitor

Services more broadly are becoming more important as consumers increase their spending on services. This isn't just a Millennial issue, or a U.S. issue; within China, services growth has outstripped manufacturing growth every quarter since Q3 2014.[7]

Conscious Uncoupling

This organic shift in the nature of trade has been compounded by an increasingly challenging approach to negotiations. In 1999, anti-globalization forces scuppered the so-called Millennium Round of the WTO talks which were to begin in Seattle. The next round was instead begun in 2001 in Doha but was abandoned in 2008 after nations failed to come to an agreement on a host of issues.[8] Policy interventions such as tariffs and state support have accelerated since the financial crisis in 2008.[9] Other slow-burning issues have included discussions about digital services taxation, and disagreement about the function of the WTO's dispute settlement board (DSB).

Since 2016, the uncoupling has accelerated, with much—although not all—of the momentum provided by President Trump, who was elected partly on the promise to rework America's economic relationship with the world. Since his election, U.S. trade policy has worked to reorient trade relationships via narrow bilateral rather than broad multilateral agreements. Moves to reconsider economic relationships are not confined to the U.S. The original Brexit vote, which preceded President Trump's election, represented a sense by the British population that the country's integration in the European economy had gone too far.

The Trump administration's decision to withdraw from the Trans-Pacific Partnership (TPP), a multilateral trade deal across the Asia region, was the first move to rework U.S. economic relations. Instead of a broad multilateral agreement like TPP, the administration instead focused on a bilateral agreement with Japan. The result was a limited agreement involving Japan lowering a few tariffs, and a digital trade agreement aimed at reducing barriers on digital trade.

> Overall, these trade policy developments highlight an increasingly limited, more focused bilateral approach to trade policy.

The U.S. Mexico Canada Agreement (USMCA) was also a relatively limited modernization of the predecessor North American Free Trade Agreement. It was updated to include digital trade provisions, a modernized intellectual property rights chapter and integrated labor and environmental chapters. The dispute settlement mechanism was reworked so that disputes take place in local courts, reinforcing the sovereignty orientation of new trade agreements.

Another bilateral deal, the U.S.-China "Phase 1" agreement, secured some concessions from China, particularly with respect to forced technology transfer. This is a specific concern which several advanced economies continue to seek to address at the WTO. The deal also addressed intellectual property rights, and some enforcement issues. A peculiar feature of the Phase 1 deal is the explicitly "managed" component—that is the import commitments by China which are effectively government-backed. This represents a fundamental shift toward outcomes-based trade and away from rules-based trade policy.[10]

Overall, these trade policy developments highlight an increasingly limited, more focused bilateral approach to trade policy. Only the USMCA qualifies as a comprehensive WTO-compliant free trade agreement. These three deals have not addressed some of the most difficult trade topics such as digital services taxation, regulatory barriers, and services trade in favor of direct efforts to reduce the overall magnitude of the U.S. trade deficit.

The Way Forward: Continued Uncoupling?

Looking ahead, there are two distinct timeframes—the period prior to the U.S. election in November 2020, and the period following. Each period has a distinct set of potential policy approaches.

Near Term Actions—2020

Certain of the Trump Administration's actions since 2016 could be viewed as a move toward bilateralism over multilateralism. As we look ahead this year, there are several trade issues that could be on the U.S. Administration's agenda, including U.S.-EU trade negotiations, the post-Brexit U.S.-UK trade relationship, as well as additional promised phases of the U.S.-China and U.S.-Japan bilateral pacts.

Given the track record of the current administration, we see it as more likely that the Trump administration to continue to promote this type of limited international agreement. Although there have been some multilateral actions—the U.S., EU and Japan recently spoke jointly in favor of engaging with the WTO to reduce forced technology transfer and state subsidies—we anticipate the preference for bilateralism in the Trump Administration to remain.

We feel trade news is likely to be relatively less volatile in 2020 than in 2019. As one of the key levers of economic policy materially under Executive Branch control, maintaining a positive trade atmosphere in the run up to the election would likely help the economy and thereby boost President Trump's re-election prospects. Many of the most critical trade issues have been apparently put to rest since Q3 2019: USMCA was ratified by the House and Senate, trade deals with Japan and China were signed, and an agreement to postpone the digital services taxation issue until 2021 has been reached with the EU.

Beyond 2020

Our long-term view on trade is more uncertain. The direction that U.S. trade policy takes after the 2020 election is likely to be driven at least partly by the result of the U.S. election itself.

As we've highlighted above, the nature of trade is changing. The topic of tariffs and goods trade represents only a declining share of international transactions taking place today. Instead, the U.S. and other countries alike face new opportunities to seize the narrative in the many areas that need resolution, and work through the very difficult policies surrounding these. Some issues are likely particularly important to work through. The rise of digital services raises a host of new issues including the cross-border movement of data as well as digital services taxation. Sovereignty issues have also become crucial, with related conflicts arising over the potential harmonization of regulatory regimes and over the DSB at the WTO. Another issue is state-sponsored capitalism and how much accommodation such a regime should be given, particularly but not solely with respect to China. Finally, there are the sincerely-held concerns about globalization—for example the populist concerns in the U.S. about the disappearance of manufacturing jobs due to globalization, or the concerns in Europe and elsewhere about the effects of trade on climate change.

These issues are expected to take time to address. As such, we anticipate a lengthy period of uncertainty as the world grapples with these issues, and as the U.S. decides how it will engage with the rest of the world. Resolution to some of these uncertainties would likely be a positive for U.S.—and global—economic growth.

Endnotes

[1] U.S. International Trade Commission, "The Economic Effects of Significant Import Restraints 6th Update," 2009.
[2] WTO, "World Trade Report," 2007.
[3] U.S. International Trade Commission, "The Economic Effects of Significant Import Restraints 6th Update," 2009.
[4] U.S. International Trade Commission, "The Economic Effects of Significant Import Restraints 6th Update," 2009.
[5] McKinsey Global Institute, "Globalization in Transition: The Future of Trade and Value Chains," January 2019.
[6] McKinsey Global Institute, "Globalization in Transition: The Future of Trade and Value Chains," January 2019.
[7] Calculations by MIM using China National Bureau of Statistics/Haver.
[8] WTO Briefing Note, "The final day and what happens next," December 3, 1999. https://www.wto.org/english/thewto_e/minist_e/min99_e/english/about_e/resum03_e.htm, accessed February 11, 2020.
[9] Global Trade Alert, "Throwing Sand in the Wheels: How Distortions Slowed LDC Export-Led Growth," 2015.
[10] Economist, "The costs of America's lurch towards managed trade," January 25, 2020.

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