

Jan Tumlir Lecture¹: Looking ahead: The New World of Trade

A Speech by Pascal Lamy at the Conference organized by ECIPE on March 9, 2015 in Brussels

I will argue that we are transitioning from an old world of trade to a new world of trade where trade opening has become a very different game. This transformation has major consequences which will likely - and hopefully - impact the international trading system, be it in terms of principles, policies, and even mandates, as illustrated, for instance, in the recent and turbulent beginning of the so-called Transatlantic Trade and Investment Partnership (TTIP).

In a nutshell – and at the risk of some simplification – the old world of trade was a world where production systems were national and where obstacles to trade were about protecting domestic producers from foreign competition. By contrast, the new world is a world where production is transnational along global supply chains of goods and services and where obstacles to trade are about protecting the consumer from risks. We are not yet totally out of the old world, we are not totally yet in the new world; we are somewhere in between. We are moving from the administration of protection – quotas, tariffs, and subsidies – to the administration of precaution – security, safety, health, and environmental sustainability. This is a new version of the old divide between tariffs and non-tariff measures.

In this new world, certain features of the old world will not change.

First: opening trade, i.e. reducing obstacles to trade or restrictions to trade, works to promote growth and welfare. On this, I very much agree with the views of your late friend Jan Tumlir. However, my own view has long been that this only works under some conditions. Creating economic gains is one thing, but creating social gains is another. I have insisted on this in the book I published just after I left the WTO, which I entitled the *Geneva Consensus*² – Geneva consensus meaning that yes, we have to open trade, but that we also have to take great care with the Ricardo-Schumpeterian impact that opening trade has on economic and social fabrics. Opening trade creates efficiencies. It works because it is painful. It is painful because it works. But the pain is more poignant for the weak. Appropriate policies are thus needed for social justice.

¹ A Czech by origin, Jan Tumlir was Director of Economic Research and Analysis at the General Agreement on Tariffs and Trade (GATT) from 1974-1992 and left an important intellectual legacy on trade.

² “Geneva Consensus”, Pascal Lamy, Cambridge University Press (2013)

Second: opening trade, i.e. reducing obstacles to trade, is about leveling the playing field and doing this in a predictable way. This takes us back to Jan Tumlir's fundamental institutional approach about the value of predictability for economic agents.

What changes fundamentally in this new world is the way to level the playing field. We don't level the playing field in the same way in protection or in precaution. Leveling the playing field in protection is fairly simply: downwards, zero! The mental horizon of all tariff negotiators has always been "zero" as long as there is nothing like a negative import tariff in economic theory, so far at least. So the system is straight forward: you get rid of the measures, you reduce them, you kill them. In the world of precaution it is a totally different game. If a European Trade Commissioner goes to the European Parliament and says "Ladies and Gentlemen, I am in favor of opening trade and for the sake of opening trade in flowers – that is a great thing for exploiting comparative advantages, notably for our African friends – I have decided to submit to you that we have different maximum pesticide residues for flowers from Rwanda because it is a poor country, for Costa Rica because it is a middle income country and for Israel as it is a high income country", it will not work! What we used to do with tariffs cannot be done with standards, certification, and conformity assessment processes. You cannot handle non-tariff measures in the same way as tariff measures. And this is where trade economists, who have rightly tried for a long time to assess the impact of non-tariff measures as tariff equivalents, have been misunderstood. Most (not all) non-tariff measures are not about substituting tariffs. They are precautionary measures, not substitutes for former protectionist measures. And what matters in precaution is not to get rid of the measure, not to "kill" the measure, not to reduce it, but to reduce the differences between the measures, and between various systems of precaution. So it's a very different thing: in the old world it is about getting rid of the measure, in the new world about getting rid of the differences in the measures that, by themselves, constitute obstacles to trade and increase the costs of trade, not least the cost of compliance with diverse regulatory systems and prescriptions.

Getting rid of those regulatory discrepancies was the transition, in Europe, between the "common" market and the "internal" market. The common market was a free trade zone without tariffs and antidumping, with serious control of subsidies that aim at protecting domestic producers from foreign competition. But a process of regulatory harmonization was initiated in 1985 so that what limited the common market in terms of economies of scale would disappear with the single market—hence this whole enterprise of regulatory convergence, harmonization, and mutual recognition.

So, opening trade in the new world has a different purpose. It also has a different political economy. In the old world, when I was a tariff negotiator I knew my political

equation: I had consumers with me who remained silent and I had producers against me who were vocal against increased competition in my domestic market. In the new world of trade the political economy is upside down. If I am in the business of regulatory convergence, I have producers with me because they are attracted by the prospect of a single standard which will enable them to realize economies of scale. Because if you remove the differences between two standards, you level the playing field and hence you provide them the sort of efficiencies that trade economists have demonstrated for a long time. But the price for that is that I have consumers against me. Or, more precisely, I have organizations that speak on behalf of the consumers (there is nothing like a referendum for consumers) – the consumer organizations – against me. Why? Simply because the business of the consumer organizations is to convince the people, its members, its followers on social networks, that if they were not doing their job then the people would be at risk. They are protecting the consumer, which is about promoting precaution.

If I start discussing with a trade partner about these standards and if my narrative is that the purpose is to level the playing field, the immediate reaction will be: “Hey, danger! They are going to lower standards! But it is my level of precaution, my level of safety, the one I care about which is going to be at stake.” And because precaution is about risk management, the reaction will be “Stop! I don’t want anything that runs the risk of diminishing my level of risk comfort,” which is another way of talking about precaution. This is a totally different political game. In the previous world, consumers were mainly silent, but in the new world of trade they become understandably very vocal. And that inevitably generates political tensions. This is all the more of a potential problem as tariffs were roughly ideologically neutral. If I exchange my tariff on bicycles against your tariffs on scrap metal, we all know what we are talking about as scrap metals and bicycles are the same all over the world. It’s ideologically flat.

But when you enter the world of precaution, the ground is no longer flat. Precaution is ideologically different depending on cultures, history or religion. Maybe not about safety of lighters, cars or toys: these are probably ideologically relatively neutral, or at least reasonably science-based. But think about animal welfare, GMOs, or data privacy. The sensitivity here is extremely different and the challenge of leveling the playing field within any range of risks is connected to values. After all, what is a risk? A risk is something that is worse than a not-risk; at the end of the day, this has to do with what is good and what is bad. And “good” and “bad” have to do with values. They are areas where the spectrum of preferences among different groups of people is extremely wide.

What also changes in this new world are the actors. Let’s remain with the example of standards of maximum pesticide residue levels in flowers. Aligning them is not only a

great thing for the two parties who do it, but also for the third parties, exporters, to this enlarged market. If I were a Rwandan exporter of flowers, I would wish that the US, EU and, if possible Japan, had the same maximum residue standard. As long as they don't, I have to adjust to different certification processes, which are costly, and I cannot deploy my comparative advantage and benefit from economies of scale because I have to segregate my exports as a function of the market destination. But it is not going to be trade negotiators who are going to adjust the top-up level of maximum pesticide residues used in flowers. This will be done by phytosanitary experts based on the impact of pesticides on human health. They are not the usual trade negotiators, nor the WTO Secretariat. Yet this impulse is driven in the name of opening trade. So it opens a whole bunch of questions, notably because agencies that are responsible for these regulations are myriad, and usually have become more independent from political power and political interests.

On top of this, many of the precautionary standards that matter for the producers are not public but private standards. Tariffs or subsidies are public, so it is sovereigns that negotiate tariffs and sign treaties which deal with tariffs or subsidies. But it is not sovereigns, in many cases, who decide on top up levels of pesticide residues for flowers, it is private companies. There is something like a multilateral pesticide residue standard somewhere in the international system. But if I am Tesco and I want to compete with Carrefour and get more consumers on my side of the street because I am "greener," I will cut a deal with a local consumer organization according to which I apply a higher level of precaution than the public standard. For the Rwandan producer of flowers it does not matter if the standard is public or private, what matters is where he sells his flowers and with which standard. On top of having the usual problem of many different rules, standards and actors, you enter another world, which is the world of private companies who have become de facto, if not de jure, prescribers of the top up levels of precaution.

Different purpose, different politics, different actors... All these differences, in my view, have major consequences for a number of principles that have for a long time been the foundation of the international trading system. Not from the very beginning, when it was not yet truly institutionalized, but with the advent of GATT and the WTO, a number of ideological pillars were built, upon which the edifice was relying. For instance: preferences. We had a lot of them in the old world, although there was a debate about whether they were right or wrong. In the new world, there are no more preferences because precaution is in itself MFN. There is no discrimination as long as I apply the same standards to my domestic production and to my imports which, by the way, was already the rule in the GATT/WTO, as enshrined in the SPS and TBT

Agreement. This turns the “special and differential” pillar of trade opening on its head, whose purpose was to be friendlier to poorer countries. It does not work anymore in administering precaution.

It also fundamentally changes the notion of reciprocity. In the old world, trade negotiation was about putting a price on a kilo of scrap metal as compared to a kilo of bicycles. The whole purpose of the negotiation was the determination of this exchange rate. It was a trade-off—an exchange of concessions. I would give you something and in return you would give me something and if we work out our deal, it is a win-win. You used to conclude when an agreement was found about the exact weighting of the value of a kilo of scrap metal against a kilo of bicycles. This is not the case anymore in the new world of trade. First, there is nothing I could trade off. I am not going to take your safety standards on lighters as a price for you taking my safety standards for toys in exchange. It may make sense intellectually, but it will not work politically. Precaution is not something you trade off. Precaution is something that we may try to harmonize. Not only the level of precaution, which is one thing important for the people who produce – this is true for goods as well as for services – but also the way in which this precaution is administered. If you take the US and the EU, for instance: in one third of the cases the EU is higher in precaution than the US, in one third of the cases the US is higher than the EU in precaution, and in one third of the cases the level of precaution is the same, but the way it is administered is so different on each side that the impact for the producer is equivalent to a different level. This has to do, for instance, with conformity assessment, and with certification procedures. Reciprocity in the new world is not about a kilo of something properly valued against a kilo of something different. It is about something, which is much, more complex: it is about the equivalence of precaution.

So to sum up, trade opening does not happen the same way in the old world and in the new world.

Before I conclude, let me now look briefly at what I believe this evolution (or rather revolution!) implies in policy and institutional terms for the international trading system.

I think it should have consequences in two areas: focus and mandates.

To start with the change in focus, let me take a simplified view of trade obstacles in the world of today. Assuming I am an average exporter wanting to step in the global market, what are the main obstacles to trade measured by average costs? I would say 5, 10, 20.

5% is the average trade-weighted tariff today worldwide

10% is the cost of border administration: what an importer/exporter of goods has to pay to clear its import/export at the border.

20% is the cost of having to cope with regulatory discrepancies in different markets, whether I have to pay to be certified, or whether I have to segregate my production, thus generating diseconomies of scale.

I once visited a company that specialized in producing extremely sophisticated medical chips. An average price is about \$5,000. During my visit I asked: “what would be the price in a utopian system with one worldwide system for clearing the sale of chips in any market?” Answer: today we have to cope with 40 different systems of certification of our medical chips. Understandably, this is highly expensive. If the system was to be unified and we had to certify only once, the average cost would fall down from \$5,000 to \$3,000. A big win indeed for patients!

So, 5%/10%/20%. I do not guarantee that my 20% is a scientifically correct number, but it is in that range. If you look at where trade negotiators are focused right now, they spend 80% of their time on the 5%, they spend 10% of their time on the 20% and they rightfully spent, recently, quite a big part of the rest of the 10% of their time which led to the Bali agreement at the WTO on Trade Facilitation. Hopefully this 10% at the border will be probably to down 5% in 10 years from now – which is great news. And that is probably the reason why the trade facilitation agreement that was at the bottom of the Doha basket progressively climbed to become a priority. It was the only area where those who trade to grow their businesses and trade negotiators themselves had a common purpose.

The focus of trade opening conversations thus should change from what matters less to what matters most. And I happen to believe that the 20% which has to do with precaution matters more than the 5% which has to do with protection, even if I recognize that an average tariff of 5% averages lower and higher numbers.

But let's also acknowledge that the 5% is ad valorem and that the 20% is usually a fixed cost. You pay for this certification once from time to time, and this cost is not related to the volume traded. The impact of this fixed cost on access to trade is higher than it appears, because big companies with large volumes can pay this as entry ticket but small businesses very often cannot. So, the potential of addressing these 20% in terms of opening trade, i.e. allowing a larger number of smaller businesses to step into the game is much bigger than its tariff equivalent.

Other areas where focus has to change, in my view, are investment, competition and taxation, which are more connected with trade in the world of value chains than they were previously. We all know that investment and trade are often two sides of the same coin. But this expansion of global supply chain and the “unbundling” of production systems also led to what the OECD diplomatically calls “excessive tax optimization.” The same goes with competition policies where differences along the global value chain

may now become more problematic. Whether these issues have to be addressed bilaterally, regionally or multilaterally, remains an open question. Take the example of regional integration in the ASEAN, in Central America or in Eastern Africa, which are probably three places on this planet where regional integration is happening quickly through trade integration. I think getting the sequence right in the new world is crucial. In these regions, the new sequence of integration is different from the old one. I don't think it makes any sense to spend hours, months and years for the East African Community to agree on a common customs tariff on cars. But setting up an airspace administration system that allocates slots regionally, or adopting common regulation for medicines marketing, for instance, makes a lot of sense because the benefits for consumers are important and usually very rapid.

In other words, the low hanging fruit and the high hanging fruit are not the same in the old tree of regional integration and the new one. Grasping this change may make a major difference in bringing the benefits of trade opening.

Opening trade in the new world also has consequences on mandates, and notably on the centrality of the WTO as the multilateral trade opening agency.

Previously, trade negotiators were harnessing trade protection downwards. "Less" was the name of the game. In the future, precaution regulators will have to harmonize precaution upwards. "More" will be the name of the game." Why? Simply because "more" is the only available political avenue as opening trade by reducing precaution is a no-go for public opinion. "More" probably also makes economic sense as the costs of upgrading precaution are usually more than offset by the gains in economics of scale for the producers. This means that the leaders of regulatory harmonization will be the ones where the level of precaution is the highest, i.e. the most developed countries. Easy to understand: just consider the correlation between GNP/head and the level of precaution. This is precisely why the TTIP makes a lot of sense, not only for the EU and US, but also for the rest of the world. But this is not multilateral. If the TTIP was to come to conclusion (and my view is that this will not happen any time soon because of its complexity), it would most probably set the world standards of protection in many areas for goods and services.

Does this mean that the WTO will be left aside? I do not believe that this should be the case for three reasons:

First: the WTO will keep administering the grey zone between protection and precaution, as prescribed by the SPS and the TBT agreements and as interpreted in the WTO Appellate Body jurisprudence, which establishes that you cannot unduly manipulate precaution for protectionist purposes.

Second: for the sake of transparency, of predictability and of stability, the WTO will have to monitor whichever process of upward precautionary alignment takes place between its main members. De facto, "under the radar screen" as it is already done regularly in the WTO SPS or TBT Committees; or de jure, if members of the WTO would organize with the Secretariat a more visible and more structured monitoring system, which they should do in my view.

Third: as the main driver of Aid for Trade since 2005, the WTO will have to adjust the technical assistance software to the new world precaution. The premises are already there if you consider the Standards and Trade Development facility, or the expertise of the International Trade Center on private standards. But given the MFN opposability of precautionary measures, development through trade expansion will only remain possible if least developed countries acquire the capacity to raise the quality of their production to the required level. This adds a large Aid for Trade area, besides existing support programs for production capacity, infrastructure, trade facilitation or trade finance.

Two final points in conclusion

What trade media tell us is that today's trade theater is about two big shows, TPP and TTIP. What they do not tell you is that TPP is in many ways the last show of the old world of trade, and that TTIP is the first show of the new world of trade. TTP is mostly, though not only, about classical protection related market access issues, which is why it will be concluded soon, likely with modest results. TTIP is mostly, though not only, about precaution relating to regulatory convergence. This process' poor progress so far stems, in my view, from the mistake made by its initiators – both the EU and US – when they decided to use a "protection minus" instead of a "precaution plus" narrative.

On a more philosophical note, trade opening in the new world is, as I already argued, as necessary as in the old world, but is also much more challenging. Because precaution is, at the end of the day, risk-related and thus value-related, it is much more politically sensitive because it makes legitimacy harder to build. It takes us back to Polanyi's argument about the dangers of disembedding the economy and society and the merits of re-embedding them, which globalization has made even more pertinent in my view, in that it enhances a tension between the two.

I believe that we are witnessing a ship race between globalization, i.e. the increasing connectedness and interdependence of our economic systems, and the capacity of our political and legal systems to level the playing field in terms of what I call "collective preferences." A discrepancy exists between the benefits of globalization on the one side and the legitimate values shared by diverse communities on the other.

The benefits of globalization go with magnitude, with size. The larger, the better. Economies of scale. Big is beautiful.

Identity, legitimacy and politics go with proximity, with small. Diseconomies of scale. Small is beautiful.

In the old world, different values systems could coexist in silos side by side. In the new world, the necessity to harmonize precaution moves production systems from coexistence under different roofs to cohabitation under the same roof, thus leading inevitably to numbed economic and political systems, because it raises the difficult question of how collective should collective preferences be, as demonstrated by the growing complexity of the EU system for GMOs authorization, or by the famous EU/Canada/Norway dispute about EU measures prohibiting the importation and marketing of seal products. A trade measure based on welfare standards for an animal the Inuit hunt as part of their livelihood and cultural tradition, which did not respect the views of Europeans.

In the world of protection, global market capitalism could live without addressing the "values" issue. In the world of precaution this issue is becoming central.

Jan Tumlr was living in the old world of trade. But he also highlighted the importance of this topic when he wrote in the 1960's "the problem of the international order is not an essentially international problem. The difficulty rather, is that virtually all the core countries are passing through a difficult crisis of democratic home governance." Fifty years later, we can definitely conclude that Jan Tumlr was a rare kind of economist: a kind of economist that can predict the future!