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TRADE AND AGRICULTURE DIRECTORATE
TRADE COMMITTEE

CONTRIBUTION OF TRADE AND INVESTMENT TO INCREASED PRODUCTIVITY, GROWTH, JOBS AND INCLUSIVENESS
(Note by the Secretary-General)

Meeting of the Council at Ministerial Level, 1-2 June 2016

Background document

Item 7: Strengthening the Contribution of Trade and Investment to Productivity and Inclusiveness

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Key messages

Given the important role that trade and investment can play in increasing productivity, strengthening innovation, increasing wages and improving working conditions, current low trade growth and below average FDI flows are worrying. With the right flanking policies, trade and investment openness can contribute to more widespread and inclusive growth.

The growing stock of protectionist and trade distorting measures is costing our economies dearly. Multilateral trade negotiations have yielded important outcomes, but much more remains unresolved and regional and plurilateral agreements only partially fill the gap.

To ensure that trade and investment play the role of stimulating economic growth to the fullest extent possible, governments should:

- Commit to a continued standstill on protectionist and trade distorting measures and dismantle those already in place.
- Proceed with market opening measures whether bilateral, regional, plurilateral, or, preferably, multilateral.
- Ratify and implement fully the Trade Facilitation Agreement and the expanded Information Technology Agreement; prioritize conclusion of the Environmental Goods Agreement and the Trade in Services Agreement.
- Build on the agreement to eliminate export subsidies and discipline export competition in agriculture, reached in Nairobi during the 10th WTO Ministerial Conference, to further integrate agriculture into global markets.
- Promote an international regulatory environment that will be conducive to the development of the emerging digital economy, so that it can contribute to growth and prosperity while maintaining appropriate levels of privacy and security.
- Promote greater coordination between trade and investment policies in order to increase their coherence, particularly for services, thereby promoting trade and investment growth in an environment characterized by global value chains.
- Explore new approaches to achieve significant multilateral market opening, including by enabling ‘ready and willing’ countries to advance negotiations under the auspices of the WTO and by integrating ‘newer’ issues into the post-Nairobi negotiating agenda.
- Incorporate trade and investment policies in comprehensive national structural reform agendas. For example, unnecessary regulatory restrictions on trade in priority services sectors can be identified by the OECD’s STRI and appropriate reforms prioritized**;** flanking policies should be designed, including strengthening skills systems and well-functioning labour markets and social protection systems.

1. Eight years after the economic crisis global growth prospects remain weak, unemployment remains high, and inequalities of income and opportunity persist. Trade and foreign investment can provide an important economic stimulus and drive productivity, inclusive growth, and better jobs for more people. Yet, global trade growth grew disappointingly by only around 2% last year. 2015 was the fourth year in a row that global trade volumes have grown by less than 3% - barely at, or below, the rate of GDP growth.

Global foreign direct investment flows in US dollars (BMD4 definition) have picked up in 2015 after several years of little or no growth.

2. Trade, an important engine for growth for reviving the world economy, is growing at a sluggish pace. There has been much discussion over the last year (including in the G20) about the possible causes of the trade slowdown – whether it is cyclical or structural in nature. The reality is - it is likely both. On the one hand, growth of trade to GDP is cyclical and depends on the growth rate of the economy. Weaker growth explains most of the post-crisis trade slowdown in the period up to around 2014, some of which was related to low growth in Europe and resulting weak intra-European trade.

3. On the other hand, some of the slowdown appears to be related to structural factors, including the stock of protectionist measures, slow progress in multilateral trade negotiations, and the People's Republic of China's transformation away from an investment-intensive economy and to its on-shoring of value chains. The trade slowdown could also be attributable to innovation and new firm strategies relying more on IP and digital flows to reach consumers abroad and less on traditional exports of products. Technological change and new business models involving more interactions with customers through services could also explain a higher incidence of the existing trade regime on trade flows with trade in services being more restrictive than trade in goods.

The role of trade and investment for increased productivity, growth, jobs and inclusiveness

4. There is compelling evidence that trade is an important driver of productivity growth: an increase in the ratio of trade to GDP by 10 percentage points on average produces a long-term increase in labour productivity between 1.4 and 9.6%[1]. The combined effect of importing and exporting spawns a process of continual resource reallocation which shifts capital and labour into more internationally competitive activities with higher productivity.

5. Exporting creates incentives for firms to invest in the most modern technologies, scales of production and worker training. Exporting firms within almost any given country tend to be larger and more productive through specialisation and economies of scale and scope. Relative to firms that sell solely on the domestic market, exporters also pay higher wages. This is partly because access to global markets allows companies to attain much larger economies of scale as fixed costs can be spread over a larger output. Imports can also drive increases in productivity via access to world class inputs, in terms of price and quality, enabling firms to improve their productivity and competitiveness both at home and abroad.

6. In addition, as many services are inputs into the productive process, they also are a driver of productivity growth and sources of employment. The OECD's work on Trade in Value Added (TiVA) and global value chains (GVC) shows that well-functioning transport, logistics, finance, communication and other business and professional services are needed to ensure a co-ordinated flow of goods and services along value chains. In fact, services represent over 50% of the value added in gross exports, and over 30% of the value added in exports of manufacturing goods. Efficient services sectors are important not just for the service component of economies, but are essential for the competitiveness of manufacturing sectors as well.

7. Foreign direct investment (FDI) also drives productivity gains through a number of channels, including technology transfer, human capital development, trade integration, and capital accumulation. Ultimately, productivity growth will stem from efficiency improvements across and within sectors, as the most efficient competitors gain market share at the expense of those lagging behind (allocative efficiency) and as competition pushes all remaining firms in the sector chain to improve their performance (firm-level

[1] OECD (2012), *Policy Priorities for International Trade and Jobs,* OECD Publishing, Paris.

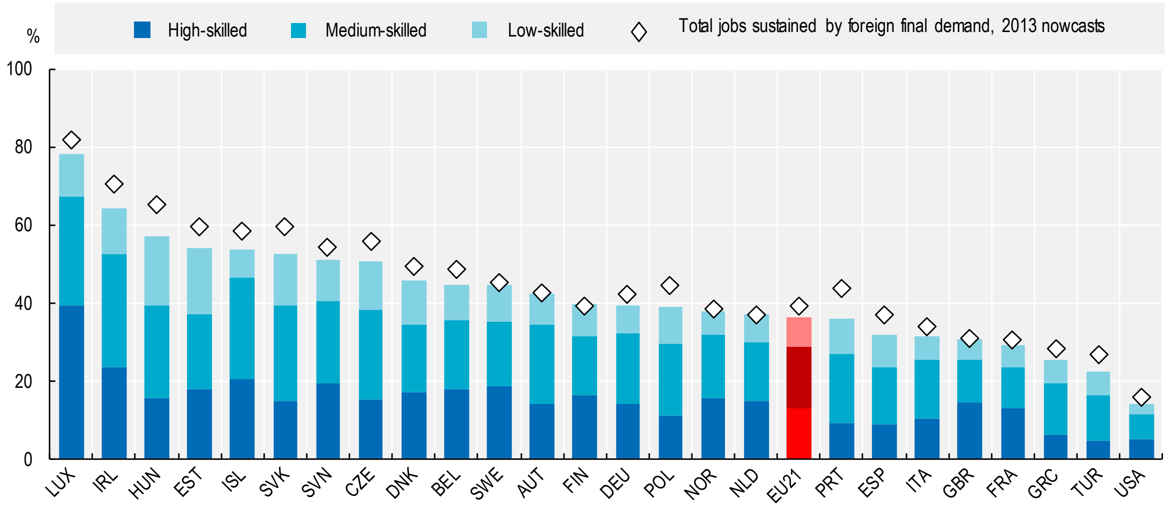
efficiency). Foreign-owned firms can play a catalytic role in this under the right conditions. They are likely to be more productive than their purely domestic counterparts because they have access to the often superior management and technology of their foreign investor. FDI can also generate productivity spillovers: both horizontally, when domestic firms operating in the same industry as the foreign-owned firm either improve their competitiveness by copying technologies or hiring workers from the foreign-owned firm or are forced out of the market if they cannot adapt; or vertically, when domestic firms in upstream and downstream sectors improve their competitiveness as a result of contact with the foreign-owned firm. There is also evidence of horizontal and vertical wage spill overs associated with FDI.

8. In addition, foreign ownership may provide improved access to international markets or further specialisation associated with intra-firm trade and integration into supply chains. FDI and multinational enterprises (MNEs) more generally are one of the main drivers of globalisation and global value chains. MNEs coordinated GVC account for 80% of the global trade (OECD, WTO, UNCTAD, 2013) and around one third of world trade is intra-firm. MNEs link and organise production across countries and are an important channel for exchanging capital, goods and services, and knowledge across countries. Nevertheless, much of the statistical work on global value chains, such as TIVA, has focused on trade and production and has been silent on the role of FDI. In response to this gap, the OECD has developed an approach that integrates FDI flows into the TiVA framework shedding new light on trade and investment, for example evidence on where income is generated along a GVC and who benefits.

9. In addition, trade and investment help generate new job opportunities which are increasingly created as part of global value chains today. Looking at trade flows in value-added terms indicates where jobs are created, highlighting the benefits of trade for all economies involved in the value chain. As shown in Figure 1, in 2013 between 15% and 80% of business sector workers in the countries for which data is available were dependent on global value chains, an increase compared to 2011, including in the share of high-skilled workers.

Figure 1. Jobs in the business sector sustained by foreign final demand, by skill intensity, 2011 and 2013 estimates

As a percentage of total business sector employment



Source: OECD Science, Technology and Industry Scoreboard 2015, based on OECD, Inter-Country Input-Output/Trade-in-Value-Added (ICIO/TiVA) database.

10. Trade can furthermore play an important role in increasing wages in both developed and developing countries, and improving working conditions. Those firms that ride the wave of continuing transition toward higher productivity in tradable activities typically pay higher wages to their workers, and these workers tend to have greater skills and be in less routine occupations. The positive effect of trade on income could reduce informality and offer new opportunities for female entrepreneurs.

11. However, whether countries realise the potential gains from trade liberalisation depends heavily on accompanying policies and the general economic environment. Accompanying policies in the form of a positive investment climate importantly support trade openness, including accommodative macroeconomic policies, adequate property rights, effective regulation, well-functioning labour markets and social protection systems. As trade does entail reallocation of resources, policies that help workers to move more quickly into new, higher productivity jobs can help attenuate human costs of normal job transitions and unemployment arising from economic shocks as well as lay the foundations for more widespread and inclusive growth. Effective training and active labour market policies are critical in this regard.

12. In addition, responsible business conduct has an important role to play. When enterprises fail to act responsibly, they risk contributing to adverse human rights, labour and environmental impacts in their operations or through their supply chains, especially in countries with weak enforcement of social and environmental standards.

Negative effects of protectionism and other market-distorting measures

13. To the extent that poor trade performance can be attributed to policy actions taken, or not taken, by governments, valuable opportunities to boost struggling economies may be lost. Policy responses by governments, including G20 governments, since the economic crisis include an accumulation of protectionist measures that affected less than 1% of global trade in 2010 but over 5% in 2015. Since October 2008 when the G20 tasked the OECD, WTO and UNCTAD to monitor G20 trade and investment measures, 1,441 new restrictive trade measures have been introduced; only 354 of these had been removed by mid October 2015. Looking beyond the G20, the stock of protectionist measures worldwide as tracked by Global Trade Alert (GTA) has also risen sharply in the last 3 years.

14. The OECD METRO model shows that the impacts of protectionist measures may be as much as a 0.5% reduction in GDP in some countries and a 0.1 percentage point increase in unemployment worldwide. The OECD report “Emerging Trade Policy Issues: Localisation Barriers to Trade” seeks to analyse a range of local content requirements (LCRs) that favour domestic industry at the expense of foreign competitors and that have been put in place since the onset of the global financial crisis in 2008 and are still in-force. The METRO Model provides evidence that these LCRs have caused global imports and total exports to decline in every region, even in those regions not implementing an LCR. There is a loss in international competitiveness as measured by the reduction in exports in non-LCR affected sectors in imposing economies. Further, as LCR affected sectors consume more domestic resources, other sectors are forced to reduce production, or increase imports, leading to a concentration of domestic economic activity. This undermines the growth and innovation opportunities that come from a diverse economy.

15. Subsidies and other support by government and government-supported institutions are contributing to global excess capacity in industrial sectors such as steel and shipbuilding. Long standing high levels of support and protection in agriculture are also distorting global markets. Increased attention to alternative policy approaches in high support sectors is warranted.

16. In the area of services trade, it is a significant finding from the OECD’s analysis (using the Services Trade Restrictiveness Index - STRI) that exports are even more hampered by services trade restrictions than imports. Figure 2 illustrates the predicted changes in imports and exports, respectively,

from reforms that reduce the STRI index value by 5 basis points from the mean. These are quite modest reforms, but the effect is substantial and the impact of reducing services trade restrictions is larger on exports than on imports. There are several possible reasons for this. First, there are few explicit barriers to cross-border trade recorded in the STRI database. Rather, the bulk of restrictions are on establishing a commercial presence, movement of people, and instances where incumbents may abuse their market power with impunity. Such regulation, and lack of anti-trust enforcement, may raise the costs and reduce the competitive pressure on domestic as well as foreign firms, rendering them less competitive in export markets. In addition, the increasing 'servicification' of manufacturing activities and the fact that many goods are now sold bundled with services has increased the incidence of services trade restrictiveness on trade and investment flows.

Figure 2.The trade effect of reducing the STRI by 5 basis points

(a) On imports (b) On exports

Source: OECD STRI Database

17. It is also important to note that the post-crisis period can hardly be characterised as a period of intensive trade liberalisation. Despite notable successes such as the Trade Facilitation Agreement, and the elimination of export subsidies in agriculture, multilateral trade negotiations have not been able to repeat the kind of major stimulus provided by the Uruguay Round Agreement, NAFTA, or the accession of People's Republic of China to the WTO. Bilateral and regional agreements have to some extent filled the gap, however adding some complexity to the international trade environment, especially for SMEs and for LDCs.

18. Openness of fast growing parts of the economy such as services and digital has not kept pace with their growing share in our economies. Unnecessary regulatory differences across countries or failure to adapt regulatory frameworks in a fast changing world may be holding back much needed growth.

Policy approaches to strengthen trade and investment as drivers of growth and prosperity

19. Against this background, renewed efforts are needed to rescind newly-introduced trade-restrictive measures, and begin to wind down, and eventually eliminate, the stock of protectionist measures that have accumulated over decades. Priority policy actions should be to keep markets open to trade and investment, resist protectionism, implement trade facilitation measures, and reform services markets.

20. Everybody stands to gain from the multilateral trading system as a driver of global trade liberalisation and rulemaking. Recent important achievements include the agreement on trade facilitation reached at the 9th WTO Ministerial Conference in 2013 and the expanded WTO Information Technology Agreement (ITA) agreed in December 2015 to eliminate tariffs on an additional 201 information technology products. An important achievement was also the agreement at the 10th WTO Ministerial in Nairobi (2015), *inter alia*, to eliminate export subsidies and discipline export competition in agriculture. While in Nairobi all WTO members remained strongly committed to advancing negotiations on the outstanding Doha issues, there remains no agreement on whether future work would continue on the basis of the DDA structure or whether new architectures, encompassing new issues, would be pursued.

21. For a number of countries 'business as usual' post-Nairobi is not an option; new approaches to achieve multilateral market opening and rulemaking need to be explored. The core interest is to allow 'ready and willing' countries to define and to advance a negotiating agenda under the auspices of the WTO, without being restrained by members that are satisfied with the status quo, and keeping the option open to all WTO members to join any negotiation or concluded agreement if and when they are ready to meet its terms.

22. A growing number of WTO members are also pursuing regional and plurilateral approaches to address the 21st century policy challenges. The Trans-Pacific Partnership (TPP) recently became the first "mega-initiative" to be concluded, while negotiations on a Transatlantic Trade and Investment Partnership (TTIP) and the Regional Comprehensive Economic Partnership (RCEP) are ongoing. Reaching to a conclusion at MC10, fifty-four WTO members took part in the negotiations to expand product coverage of the WTO's 1996 Information Technology Agreement (ITA). A new plurilateral WTO Environmental Goods Agreement is being negotiated to eliminate tariffs on environmental goods. The Trade in Services Agreement (TISA) is the most promising opportunity in two decades to improve and expand trade in services.

23. These initiatives are welcome and all efforts should be made to conclude and to implement them, but governments should also strive to strengthen, globally, policy coherence in the area of trade and investment. Global trade and investment flows are governed by a complex array of bilateral, regional and multilateral rules – some centered on trade, others on investment - that intersect at multiple levels. While these agreements are largely complementary, there are also overlaps, inconsistencies, and gaps in their coverage that can entail unnecessary costs for businesses. Eliminating these unnecessary costs would encourage increased trade, investment and subsequently growth. As global businesses increasingly pursue joined up trade and investment strategies, there is a corresponding need for greater domestic policy cooperation and coherence.

24. The challenge now is to find a flexible pathway to resolve the outstanding issues and a number of so-called 'new(-er)' issues of most concern to businesses, some of which are already beginning to be addressed in recent RTAs. These include trade and investment measures in relation to *environment* (including incentives for renewables and fossil fuel subsidy reform) and *competition* (including the operation of state enterprises, government procurement, and export financing). All warrant attention, but perhaps the policy areas most urgently demanding attention from the perspective of businesses are *trade and investment* (and the range of implicit and explicit restrictions on imports, exports and FDI), *the digital economy* (and appropriate policy responses to maintain the desired degree of openness, address legitimate privacy and security concerns, and contribute more to growth and jobs), and *services* (and restrictions on their free movement):

– The international fragmentation of production both influences and is influenced by evolving business *investment* strategies. Developing policy approaches to help unlock private investment would be usefully informed by new analysis to: clarify the range and relative importance of implicit and explicit restrictions on investment; identify the WTO-beyond and WTO-plus provisions in bilateral and regional agreements, assess whether there is more or less convergence across measures and countries, and highlight the policy implications to explore possible next steps; and, clarify how international business supply chain strategies are evolving and their impact on SMEs, LDCs and associated trade, investment and flanking policies.

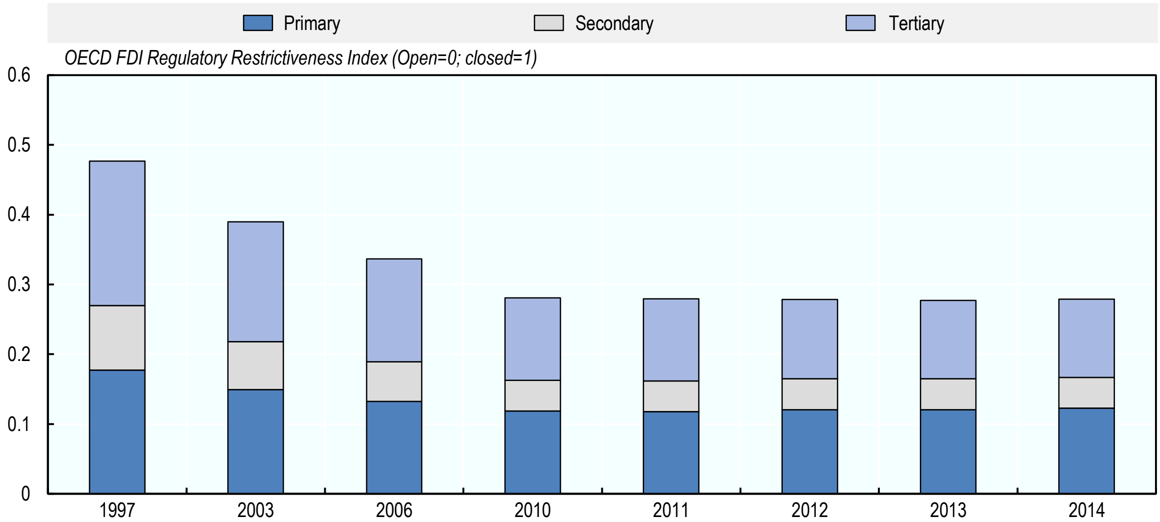
- The *digital economy* is also shaping business strategies and beginning to influence areas of public policy. Technological innovations (big data, 3D printing, the internet of things, e-commerce, mobile pay systems, etc.) can be viewed as having a 'disruptive' or an 'enabling' impact on trade and investment. One element, among others, requiring further analysis is the role of intellectual property rights in facilitating innovation, both via new R&D investments and wider diffusion of knowledge and ideas across borders. Better understanding these developments is pre-requisite to refining appropriate policy responses and embark on further collaboration to define the international regulatory environment that will maintain the desired degree of openness and contribute to growth and jobs while addressing legitimate privacy and security concerns.
- *Services* account for over 60% of GDP in G20 members, as much as 80% in high income countries, and almost 50% in some low income countries. The value of services as intermediate inputs in manufactured goods exceeds 30% and the direct and indirect services content of trade exceeds 40% in G20 members. Services reform has been hampered by a lack of systematic information on restrictions to their free movement; this gap is now being filled by the OECD STRI, but more can and needs to be done.

25. National efforts can also significantly stimulate trade and spur economic growth. Individual governments can themselves focus greater attention on trade and investment opening as one element of their comprehensive national structural policy reforms. For example, inefficient customs and other border procedures also impose unnecessary costs on traders. The OECD estimates that simply implementing the already agreed WTO Trade Facilitation Agreement would reduce trade costs for business by up to 17.5% in some countries. A 1% reduction in global trade costs would increase worldwide income by more than USD 40 billion. Importantly, low and lower-middle income countries would gain the most. Voluntary collective actions can also be envisaged, for example in the context of G7 or G20 processes, as was pursued with some success under Australia's G20 Presidency.

26. There is also scope for countries to move unilaterally to improve their economies' openness to, and attractiveness for, foreign direct investment (FDI), particularly in the services sector. On average, countries have progressively liberalised their FDI regimes in recent decades, albeit with occasional relapses (Figure 3). But, worldwide, many service sectors remain partly off limits to foreign investors, holding back potential economy-wide productivity gains. Even within OECD countries, restrictions on foreign investment remain in key services sectors such as energy and transport, with important productivity implications for downstream sectors. Recent OECD work[2] has documented that open and efficient markets for services are fundamental to underpin participation in GVCs, and hence to facilitate the diffusion of new technologies. FDI is an important component in this regard to help enhance knowledge flows and technology transfer to the economy and to accelerate competition, which boosts growth and productivity.

[2] OECD (2015), *The Future of Productivity,* OECD Publishing, Paris.

Figure 3. Evolution in FDI Regulatory Restrictiveness, by sector, from 1997 to 2014



Source: OECD FDI Regulatory Restrictiveness Index database, http://www.oecd.org/investment/fdiindex.htm.

27. The 2030 Agenda for Sustainable Development explicitly recognises that trade and investment are means rather than ends in themselves. While the economic case for increased trade and investment openness as an integral part of a structural reform agenda is clear, it is also clear that the distribution of the benefits is not automatic. Flanking policies that accompany market opening and that respond to the specific needs of countries at different stages of development, including policies related to labour markets, education, responsible business conduct, and social protection, are also needed to ensure that benefits of trade and investment are widely shared.

Conclusion

28. There is a range of actions that could be taken by governments to ensure that trade and investment play the role of stimulating economic growth, jobs and inclusiveness to the fullest extent possible; governments should:

- Commit to a continued standstill on protectionist and trade distorting measures and dismantle those already in place.
- Proceed with market opening measures whether bilateral, regional, plurilateral, or, preferably, multilateral.
- Ratify and implement fully the Trade Facilitation Agreement and the expanded Information Technology Agreement; prioritise conclusion of the Environmental Goods Agreement and the Trade in Services Agreement.

- Build on the agreement to eliminate export subsidies and discipline export competition in agriculture, reached in Nairobi during the 10th WTO Ministerial Conference, to further integrate agriculture into global markets.

- Promote an international regulatory environment that will be conducive to the development of the emerging digital economy, so that it can contribute to growth and prosperity while maintaining appropriate levels of privacy and security.

- Promote greater coordination between trade and investment policies in order to increase their coherence, particularly for services, thereby promoting trade and investment growth in an environment characterised by global value chains.

- Explore new approaches to achieve significant multilateral market opening, including by enabling ‘ready and willing’ countries to advance negotiations under the auspices of the WTO and by integrating ‘newer’ issues into the post-Nairobi negotiating agenda.

- Incorporate trade and investment policies in comprehensive national structural reform agendas. For example, unnecessary regulatory restrictions on trade in priority services sectors can be identified by the OECD’s STRI and appropriate reforms prioritised; flanking policies should be designed, including strengthening skills systems and well-functioning labour markets and social protection systems.