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Strengthening the Multilateral Trading System
Discussion Note 1

Main Messages

- Given the emergence of regional and global value chains, new measures of trade in value-added terms are needed to identify where income and jobs are created as goods and services cross borders multiple times. Better information on how trade opening and adjustment assistance benefits countries, firms and individuals could help to strengthen public support for open markets.

- On the other hand, tight government budgets and high unemployment increase pressure on governments to restrict trade. G20 governments must demonstrate leadership by standing firm in rejecting 'beggar thy neighbour' policies in all forms.

- G20 discussions to date have focussed, rightly, on monetary and fiscal policies. But the time has come to pursue active and ambitious market opening as an integral part of the structural reform agenda. This includes improving institutional frameworks, regulations and measures to reduce unnecessary costs both at the border and behind-the-border.

- Ambitious market opening in traditionally high support sectors, such as agriculture and manufacturing is required, but it is also essential to open markets for services trade. Services not only provide the bulk of new employment and income in many countries, but in areas such as the financial and telecommunications sectors, they provide vital input for the production of other goods and services.

- To ensure more inclusive growth and better employment outcomes, more open markets must be accompanied by complementary policies that enable individuals and firms to adjust and to take advantage of new opportunities, while providing social protection to those unable to do so. G20 trade opening can generate an additional stimulus that will create employment opportunities for the world as a whole.

Setting the Scene

Over the last half century ***the global expansion of trade has reshaped the world economy***. The share of world trade in global output is now three time what it was in the early 1950s. More open markets have enabled economies to focus more productively on what they do best and to reap the benefits of specialisation. Openness has fuelled competition by not only offering new opportunities for sales (i.e. exports), but also by making available to producers the widest range of inputs at the highest quality and lowest prices (i.e. imports). Consumers, both individuals and businesses, have enjoyed better prices and increased choice, while competitive firms have gained reliable access to needed inputs and larger markets.

Empirical research shows that exporting firms are generally more productive than non-exporting firms, and typically rank among countries' most prosperous businesses. Higher productivity is also associated with higher wages and more prosperous communities. In countries for which data are available workers in firms and sectors with high export-intensity earn a substantial wage premium and show above-average labour productivity. By implication, communities with large numbers of export-reliant firms are more likely to enjoy growing tax bases.

Imports play an important role in achieving better economic performance by making available "world class" inputs and capital goods, but also by providing incentives for firms to innovate by adopting knowledge, ideas, know-how and best practises from abroad. Openness allows all countries to absorb technologies developed elsewhere, and to grow, at a faster rate than countries that are less open. A more open domestic market is far from being a handicap; it is a source of competitive strength.

At the same time, trade and innovation contributes to needed structural adjustments. While the positive relationship between trade, growth and economic development is well-documented, the relationship between trade and jobs is complex. More inclusive growth and better employment outcomes require other policies to complement market openness: education systems that enable individuals to acquire the needed knowledge and skills, active labour market policies that assist workers to shift from areas of declining demand to new growth sectors, and social protection for individuals needing time to adjust. In some cases, investments in physical infrastructure are required to help turn potential new business opportunities into reality.

Structural reform induced by trade and trade policy has been substantial in recent years. Trade openness has been important in many developed economies; average industrial tariffs, for example, have been reduced to less than 5% in the EU, US, and Japan. The emergence of the BRICS – China and India most notably – as major players in the international marketplace has induced significant structural change throughout the world. Tariffs in many developing and emerging markets have fallen substantially; while their levels tend to still be higher than in OECD economies, trade openness is contributing to efficient structural reform in their economies. The result has been rapidly-rising per capita GDP growth and a massive reduction in poverty rates in emerging economies.

Another major structural change is ***the emergence of regional and global value chains***. The whole process of producing goods, from raw materials to finished product, is increasingly carried out wherever the necessary skills and materials are available at competitive cost and quality. Advances in information and communications technologies have helped make this possible for both goods and services. While manufactured goods still account for the largest share of international trade (75%), improvements in technology, standardisation, infrastructure growth and decreasing data transmission costs have all facilitated the sourcing of services from abroad. In particular, "knowledge work" such as data entry or research and consultancy services can easily be carried out via the Internet and e-mail, and through tele- and video-conferencing. In effect, estimates of the share of services in trade are significantly underestimated because of measurement difficulties associated with electronic transmissions and because services are often embedded in physical goods.

So the "value chain" for any particular business – the value added by different processes or activities at each stage of production – is now regional or even truly global in nature, rather than national. This international fragmentation of production is a powerful source of increased efficiency and firm competitiveness. Today, more than half (56%) of world manufactured imports are intermediate goods (primary goods, parts and components, and semi-finished goods), and 73 percent of world services imports are intermediate services.

This heightened integration has implications for the impact of trade and investment barriers both on the country implementing the measures and on the global economy. When an economy is part of a vertically-integrated chain with complex ownership structures, a disturbance in any part of the link can disrupt the entire chain. Policies that restrict access to foreign sources of intermediate goods and services will also have a detrimental impact on a country's position in the regional or global supply chain. Because tariffs on intermediates would increase the cost of production and reduce overall competitiveness, firms could be discouraged from investing, or even from maintaining investment, in a country. Tariffs on intermediate inputs that typically cross borders several times are cumulative; they can thus add up to impose punitive costs on downstream users and eventually final consumers, and as a consequence stifle demand. As such, trade restrictive policies are more likely to produce firm closings and job losses – the very outcomes they were designed to prevent.

As goods and services cross borders many times before being purchased by final consumers, traditional trade statistics also count these transactions multiple times, leading to a highly distorted picture of reality. In response, OECD and WTO have launched an initiative to measure trade on a value added basis. In contrast to current indicators of gross trade flows, value added statistics would provide an accurate view of the underlying economic importance of trade. By identifying where value is being added, it will be possible to identify accurately where income and jobs are created. In addition, it will allow for a more accurate picture of bilateral trade imbalances. For example, some recent studies have estimated that the US-China trade balance is significantly different when measured in value-added terms than when measured by gross trade flows, as at present.

G20 governments could lend their support to on-going efforts to measure trade in value-added terms and to identify the implications for trade policy, and in particular for the importance of strengthening the multilateral trading system.

Keeping Markets Open

Despite the fact that open markets generate clear net benefits, circumstances of (short-term) adjustment pain lead to calls to protect industries and workers against competition from abroad. Societies pay a high price for heeding such calls. Protection rarely tackles the underlying policy requirement of adjustment, efficiency gains and competitiveness. It encourages firms to engage in costly and wasteful lobbying, and sustains inefficiency and further dependence on protection. Once in place, protection is also difficult to dismantle.

Barriers to trade raise the price of both imports and domestic products, restrict consumer choice and usually lower quality by relieving competitive pressure. Protectionism fragments markets, limiting opportunities in the exporting country to lower production costs from specialisation and access to "world class" inputs. And by raising prices, higher trade barriers act like a tax hike.

Empirical research has even shown that the average cost of a job protected by trade barriers far exceeds the wages of employees whose jobs are "saved". This is a wasteful use of resources that societies could more usefully allocate to job training and other assistance for displaced workers.

The G20 countries have thus far demonstrated their willingness to act collectively to resist protectionist measures that could erode progress already made towards more open global markets. Despite the adoption of some trade policy measures that violated the spirit of the G20 "standstill" agreement of November, 2008, governments did not resort to protectionism on a significant scale during the crisis. Import-restricting measures adopted during the crisis and to date affect less than 2% of world trade.

This does not mean that we should be complacent. As highlighted in the latest OECD-WTO-UNCTAD report on G20 trade and investment measures covering the period May to October 2011, the incidence of protectionism in that period was as high as the most worrying quarters in 2009, when crisis-driven protectionist fears were at their peak.

Protectionist sentiments can be expected to mount with persistent unemployment and mounting pressure on government finances. Even in the absence of any escalation in overt protectionist actions, the danger is that restrictions build up incrementally, slowly stifling trade and ultimately weakening the effectiveness of the anti-cyclical stimulus measures that have been introduced. Once put in place, protection may become entrenched and difficult to undo. ***It is imperative that governments abide by the commitment made at the G-20 to resist protectionism in all its forms, and to roll back potentially anti-competitive measures in a timely manner***. This commitment might be facilitated through a better dialogue among trade ministers to understand the root causes of protectionist pressures.

In the current policy environment a more open trading regime would provide a much needed and debt-free source of stimulus for the world as a whole, while at the same time helping to achieve a more inclusive and balanced global economy.

An immediate opportunity to boost trade worldwide is to ***reduce trade costs associated with moving goods across borders***. These costs include inefficient border procedures, costly customs procedures, and even lost business opportunities. And all these costs ultimately make goods more expensive for the consumer.

Growth in international trade generally, and the emergence of regional and global value chains in particular, mean that more goods and services cross more borders, more often. Every time they do, they have to comply with a range of border procedures and customs formalities. Complex or inefficient border measures can increase trade costs, with estimates ranging from 2% to 15% of the value of traded goods.

In some cases trade costs at the border may be sufficiently high, such as in the case of significant or uncertain time delays, as to prohibit trade entirely. Inefficient border procedures also cost the governments that administer them, in terms of reduced trade flows, lost revenue, and increased smuggling. If export competitiveness is reduced as a result of high trade costs, the country concerned might even become less attractive as a place for investment.

Highly integrated regional and global value chains with "just-in-time" inventory systems, for example, rely on the uninterrupted flow of intermediate inputs. Such international production networks cannot operate in an environment where imported or exported products are delayed at the border because of unnecessary or over-complicated procedures.

G20 governments can demonstrate leadership to prevent any further deterioration in their collective policy stance to resist protectionism in all its forms, and to roll back potentially anti-competitive measures in a timely manner. G20 governments can also act, individually, to reduce costs and improve efficiency of their border procedures and customs formalities.

On-going monitoring of protectionist measures by WTO-OECD-UNCTAD should continue and should be complemented with periodic assessment of the impact on trade of actions taken. Work underway at the World Bank, OECD and elsewhere that aims to identify unnecessary trade costs at the border should be strengthened, with a view to clarifying best practises that could be considered by governments.

Contributing to More Inclusive Growth and Employment

The OECD, WTO, ILO, and WB joint report presented to the Seoul G20 Summit, *Seizing the Benefits of Trade for Employment and Growth*, explored available evidence on how trade contributes to growth, development and job creation. That report included preliminary analysis estimating that a 50% cut in goods tariffs and non-tariff barriers by the G20 countries would lead to significant increases in national income for all G-20 countries and their partners.

One clear pattern in the structure of the global economy over the past twenty years has been a shift towards services. Services have assumed increased importance in all country groupings, accounting for the largest share of GDP in high-income countries (71%), middle-income (57%) and low-income countries (45%). But in comparison to goods, trade in services remains relatively low and stagnant owing to high rates of border and behind-the-border protection. The economy-wide costs of these barriers can be significant. The cost and quality of services inputs such as telecommunications, distribution, and financial intermediation are key determinants of the competitiveness of firms.

A rapidly growing body of evidence has documented the linkages between the efficiency of service sectors, the productivity of "downstream" companies that use the services as inputs, the skill-intensity of production, the demand for educated workers, and the wages that they earn. The policy implications are significant: regulatory reforms that reduce entry and operating costs for foreign services providers should stimulate investment and output, with positive employment effects. Some domestic firms may have to adjust, but others in the same sector will expand and generate new demand for labour.

Further opening of services trade constitutes a major economic opportunity with positive labour market implications. An inefficient service sector acts like a prohibitive tax on a national economy. For this reason, the economic cost of protecting inefficient service sectors is arguably of greater overall significance than that flowing from protectionism in the goods sector.

Going further, recent OECD work suggests that asymmetric patterns of liberalisation – that is, higher world-wide trade barriers in services as opposed to goods – may have played a role in the build-up of large current account imbalances. Since services account for most non-labour costs of production, reforms that would improve the efficiency of services should be a major focus of policy in deficit countries, complementing policies to switch the pattern of expenditure and reduce net consumption. In surplus countries, where services barriers are relatively higher than in deficit countries, expanding domestic consumption and investment should also focus on services such as financial intermediation, insurance, retail distribution, and related logistics. Expanding the scope for international trade and investment in services can help generate the required structural changes.

This is not to imply that sectors traditionally characterized by high levels of support and protection, such as agriculture and manufacturing, are not important. Market opening is clearly desirable in these sectors, and doing so is essentially a matter of political choice. The available evidence suggests that the benefits would be significant, and that in the short term they would accrue largely to the countries that today provide the highest levels of protection and to currently competitive suppliers in world markets. Over time, and with investment in improving supply capacity, a large number of less developed countries can also be expected to benefit.

The opening of markets in both goods and services creates potential opportunities, and for these to be realised and for the benefits to be spread widely, complementary policies are needed. Effective education and training systems enable individuals to acquire and maintain the needed knowledge and skills to obtain meaningful employment; active labour market policies assist workers to shift from areas of declining demand to new growth sectors; and social protection schemes support individuals and families, helping to provide the time needed to adjust.

With multilateral negotiations at an impasse, G20 governments should reflect further on the contribution that trade opening – particularly services trade – and appropriate complementary policies can make to needed structural policy reforms, more inclusive growth, and employment.

While ample information is available to facilitate opening markets in agriculture and manufacturing, much less is known about the impact of various border and behind-the-border measures affecting services trade. On-going work at the OECD to build a regulatory database of measures that may restrict services trade, by country and sector, and to quantify the likely impact of trade restrictive measures, could usefully be accelerated.

Conclusion

During the past few years the global economy has slowed considerably, world trade growth has fallen, and the economic outlook today is highly uncertain. Unemployment remains stubbornly high and public budgets are at unsustainable levels in many countries. The WTO Doha Development Agenda (DDA) remains deadlocked and many governments are shifting attention from multilateral to regional trade arrangements. With tight government budgets, high unemployment, slower growth, and the prospect of further multilateral market opening seemingly slipping away, the threat of protectionism looms ever larger.

Further trade opening constitutes a potentially important source of confidence building and economic stimulus. Reducing barriers to economic integration by lowering trade costs and reducing discrimination in international trade, when accompanied by appropriate active labour market and social protection policies, can deliver better growth and employment outcomes. This applies in particular to services trade where the share in GDP is the largest and where barriers to international specialisation are the highest.