



International trade rules for global prosperity: Principles and Power

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Motivation

- Revival of industrial policies
 - Both history and the events of today tell us that the powerful try to modify the rules when they no longer serve them
- Key question:

How should international trade rules be designed to promote global economic development and prosperity?

Jake Sullivan's speech at Brookings Institute, 04/27/2023

“By the time President Biden came into office, we had to contend with the reality that a large non-market economy had been integrated into the international economic order in a way that posed considerable challenges.

The People's Republic of China continued to subsidize at a massive scale both traditional industrial sectors, like steel, as well as key industries of the future, like clean energy, digital infrastructure, and advanced biotechnologies. America didn't just lose manufacturing—we eroded our competitiveness in critical technologies that would define the future.”

Who shapes the rules for international trading?

- Workers' interests – even those from advanced nations – are generally underrepresented in international negotiations
- Corporate interests have a disproportionate influence in international trade ministries, and thus have disproportionate influence in shaping the international rules
- The US corporate sector has played a decisive role in the construct of WTO rules

Standard international trade doctrines

- WTO rules are “officially” based on the core neoliberal assumptions that give rise to the fundamental theorems of welfare economics:
 1. markets allocate capital efficiently;
 2. the type of economic growth does not really matter
- Theory predicts that under free trade countries will specialize in the production that is intensive in the use of the factor that is relatively abundant
- The standard theory predicts that trade leads to an increase in global efficiency—and *within each country* the winners from trade liberalization would be able to compensate the losers

Two fundamental problems with the standard theory

1. It leaves power aside, hence it ignores the political processes that determine the allocation (and re-allocation) of resources in a society
 - Redistribution from the winners to the losers not only hardly occurs, but the changes in the distribution of income and wealth affect the distribution of power, reinforcing inequalities to an extent that can become dysfunctional for societies
 2. The fundamental theorems of welfare economics assume that there is no innovation
 - The lack of innovation trivially implies that countries cannot change their comparative advantage, typically implying that the static comparative advantage coincides with the dynamic comparative advantage
- With endogenous innovation, there is a role for investment in learning and the type of growth does matter

How should global trade rules be designed to promote the development of sovereign nations?

- **Case I:** the decentralized “competitive” solution
- *Environment:*
 - Each country has its own welfare function
 - No - spillovers
 - No global political system for redistribution or to ensure fairness
 - Rough symmetry—no country has economic power
- *Equilibrium:* trade war in static environment; cooperation might emerge in dynamic environment
- *Solution:* international trade rules that punish “distortive” policies

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- **Case II:** first-best global solution
- *Environment:*
 - Well-defined global welfare function
 - Global political system that enables redistribution
- *First-best:*
 - Innovation happens in region with comparative advantage to innovate, it is globally funded, and benefits of innovation are shared
- Incompatible with world composed by multiple sovereign nations with large disparities in economic and political power

How should global trade rules be designed to promote the development of sovereign nations?

- **Case III:** the decentralized solution with “constrained” power
- *Environment:*
 - Each country has its own welfare function
 - No internalization of spillovers
 - No global political system for redistribution
 - Countries with different power:
 - The most powerful shape the international rules, no perfect competition of nations
 - But once set, international rules are respected (“constrained” power)
- *Equilibrium:*
 - Powerful countries set international rules that maximize their expected welfare
 - Investment in innovation will be suboptimal
 - Innovation at the country-level will not add proportionally to the global pool of knowledge
 - Inequalities will be perpetuated and magnified

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- **Case IV:** the decentralized solution with international rules (and its enforcement) determined by power – Power abuse
- *Environment:*
 - Each country has its own welfare function
 - No internalization of spillovers
 - No global political system for redistribution
 - Countries with different power
 - The most powerful shape the international rules
 - Power determines enforcement of international rules, a country that is “too powerful” may not respect the rules if it’s no longer convenient but enforces other countries’ fulfillment of the rules
- *Equilibrium:*
 - Abuse of power (like current international architecture, WTO)
 - Powerful countries set international rules ex-ante that maximize their expected welfare, powerless countries obey the rules, powerful countries may not enforce the rules ex-post if they are no longer welfare-enhancing
- Rules increase global inequality

How should global trade rules be designed to promote the development of sovereign nations?

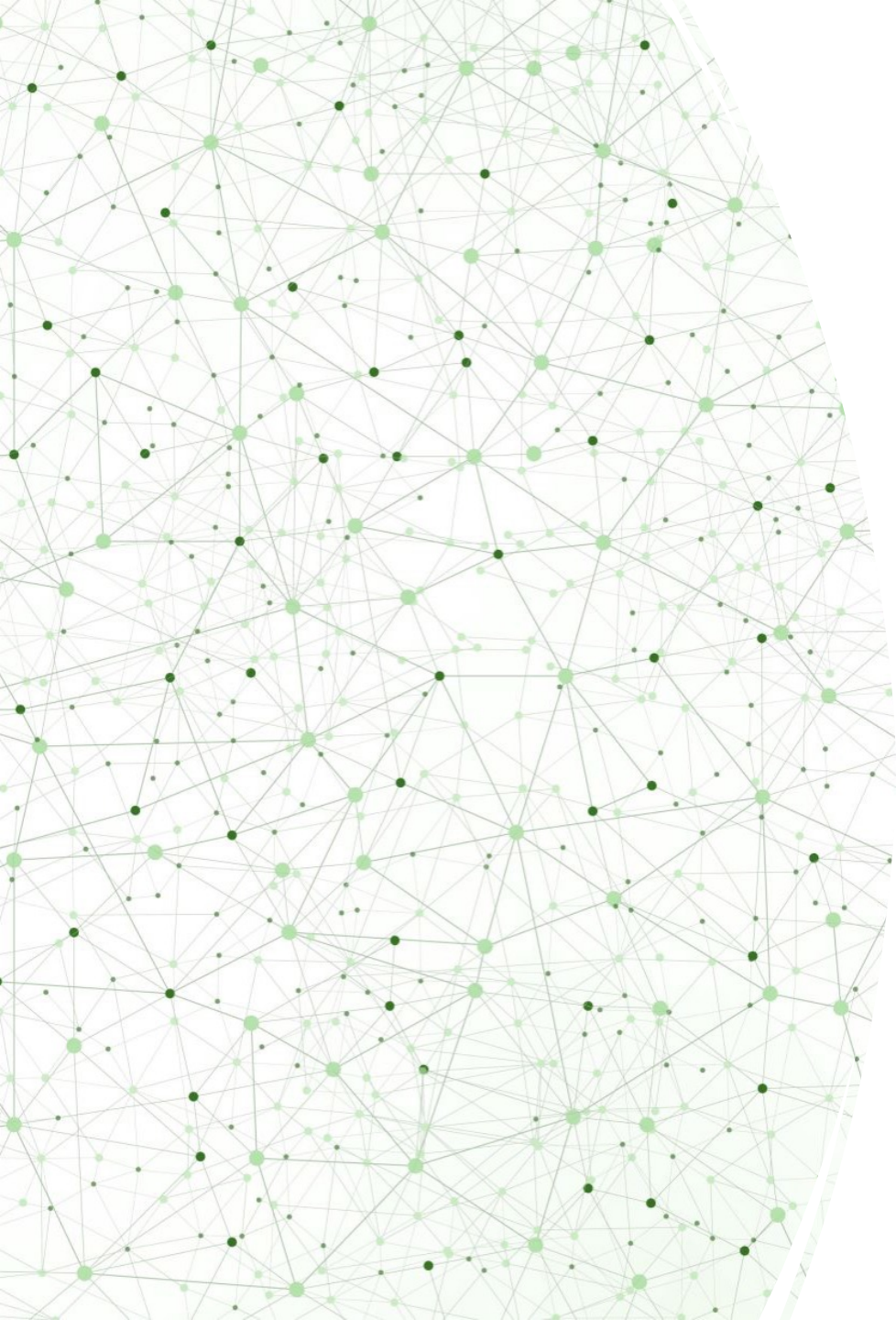
- **Case V:** the decentralized solution with international voting
- Environment:
 - Each country has its own welfare function, no internalization of spillovers
 - No global political system for redistribution
 - Countries may have different *economic* and *financing* power
 - There is a voting system for international trade rules
 - Once set, rules are respected by all
- Equilibrium:
 - It will depend on the probability density function of countries' power
 - The poorer will want a more distributive global policy and the wealthier a less distributive
 - Meaning that the poorer (further ahead from the knowledge frontier) will vote for global policies that maximize the diffusion of knowledge across borders (no IPR/patents) while the wealthier will vote for the opposite (more stringent IPR/patents)

A fair and compassionate solution

- Set of rules based on how they might have written behind a veil of ignorance, before each individual in each country knew where he was to be born—thinking about the matters partially at least through the lens of Rawls
- A “fair” agreement might allocate the surplus generated by global cooperation equally. A compassionate solution might allocate a larger amount to those whose initial conditions were worse off
- *A first constituent of a fair and compassionate trade agreement with endogenous technology is that if the developed countries provide industrial subsidies, they must provide incremental assistance for similar purposes for developing countries*

Concluding comments on international trade rules for global prosperity

- These historical patterns raise the question of whether there can really be an international rule of law
- This paper provides no answer to that question
- Instead, the paper addresses the question of how the rules for international trading *should* be designed, assuming that it is possible to have *some* rule of law



Framing the international
trade architecture in the global
context:

Moving to a multi-polar world
with diffuse power

Moving to a multi-polar world with diffuse power

- Marked by strong polarization
- New cold war, but divisions markedly different
 - Not centering around ideology—though that was partially a façade
 - The US even overthrew democratic governments and promoted dictators
 - Many leaders of emerging markets today educated in West, pro-market—but anti-hypocrisy, against abuses of power, concerned about wellbeing of citizens
 - Don't want to pick sides—even if there is a clear “right” and “wrong,” as with Russia's invasion of Ukraine
- Opening up the potential for large changes in the global economic architecture

Multiple legitimate grievances

- Vaccine apartheid—putting profits of drug companies over lives in developing countries
- Hypocrisy of industrial policy—telling countries not to employ industrial policies until it serves their own interests to do so
- Failure to keep promises--.7% of GDP for foreign aid, \$100 billion to help in green transition
 - With developing countries suffering from more than two centuries of pollution by the advanced countries, and now being threatened that they must go green quickly
- A global tax reform that delivered almost no money to developing countries and did too little to curb secrecy havens
- A system of global economic governance that gives little voice to developing countries—even if they are more often invited to the table
- A global financial system where developing countries are buffeted by the vagaries of the West (including by their Central Banks), where the large countries take no account of the externalities they impose, but the developing countries are told not to take actions to protect themselves against these externalities

Multinational corporate tax reform

- Transfer pricing system has long been broken
- Developing countries in desperate need for funds; all countries felt need after 2008 crisis
- OECD Base Erosion and Profit Shifting initiative began with best of intentions
 - Avoid tax shifting, making companies pay fair share of taxes
 - Based on principle of taxing rights being allocated on basis of where economic activity occurs
 - G-24 put forward concrete proposals
- What emerged?
 - Global minimum tax—set at too low a level and with large “carveouts”
 - An allocation of taxing rights of little benefit to developing countries and emerging markets
 - These countries would have to give right to impose digital and other taxes, likely to be of increasing importance in future—for some countries “reform” might lead to loss of revenues
 - Voice of developing countries and emerging markets had not been heard
 - Voice of economists had not been heard: BEPS reflected corporate interests and political power, not good economic principles
- So badly designed that not even US is likely to sign: a lot of effort for nothing
 - Fresh start in UN
 - Called for by AU, should be supported by Latin America, should be pushed in G20

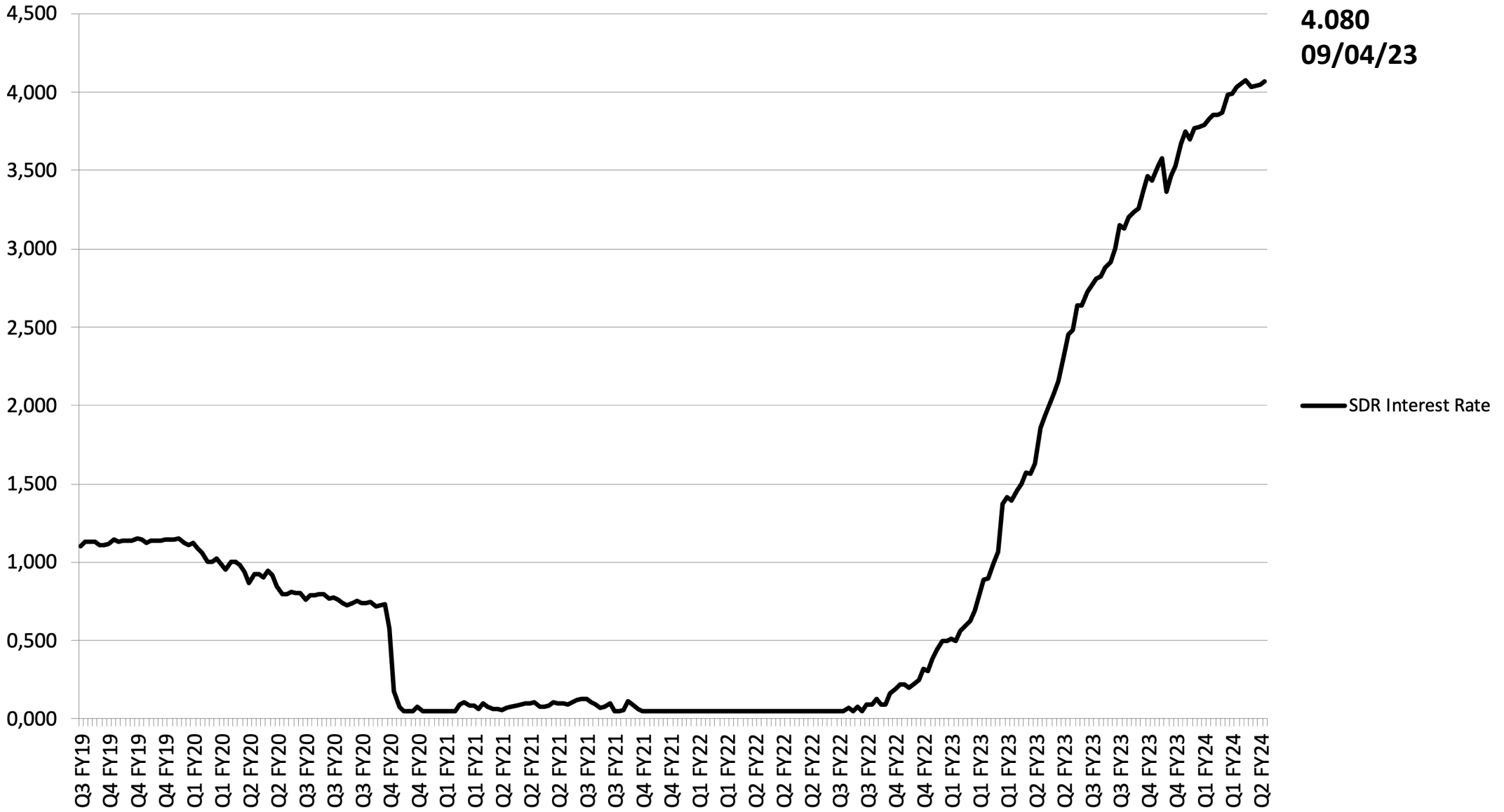
Global financial system

- Legacy of long era of low interest rates and absence of capital account regulations
 - Many developing countries now over indebted
 - Problems compounded by Covid-19 and oil and food price shocks
 - Risk of debt crisis in many countries
- But still no framework for resolving sovereign debt
- In spite of UN resolutions with overwhelming support in 2014 and 2015, endorsing recommendations of Stiglitz Commission
- Private contracting (collective action clauses) shown not to be sufficient

Further difficulties of debt resolution

- Borrowing from IMF has become very expensive and insufficient given the disproportionate growth of private liquidity
 - Interest rate linked to SDRs rate has gone up with Fed, ECB and BoE's rate hikes
 - Surcharges added on

SDR Interest Rate



4.080
09/04/23

— SDR Interest Rate

Further difficulties for development financing

- High interest rate also problem for countries turning to MDBs for financing green transition
 - Many economically viable projects to accelerate green transition if cost of capital can be kept at reasonable level
 - MDBs need to be recapitalized and new green industrial banks need to be established
 - Including financing for green technology, to “correct” new imbalances in the global economic order presented by IRA and green subsidies

Broader issues

- There is a new balance of economic and political power emerging—markedly different from that of 1944, or even 1990 (the end of the Cold War)
- The advanced countries are loathe to take on board the full implications
- Democracy is in retreat—but democracy is the only way forward that will lead to broad and inclusive societal wellbeing
- Democratic institutions have to be strengthened to withstand the assault from demagogues, populists, and authoritarians
- Overlapping but distinct alliances
 - Democracies
 - Emerging markets and developing countries
- Brazil and Indonesia, as the two largest functioning democracies in the emerging markets, need to take a leadership role in shaping agenda, norms, and institutions in the new global economic order