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## Walking a Tightrope

### World Trade in Manufacturing and the Benefits of Binding

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Is the Doha Round worth the efforts currently devoted to it? Many people—and in particular many industrialists in Europe and the United States—are not convinced. Recent estimates of the gains from what is on the table at the World Trade Organization (WTO) in Geneva are fueling these doubts. Indeed, such small gains should hardly come as a big surprise after two decades of industrial tariff cuts by the largest (developed and emerging) world economies. For instance, the average applied tariff of the 34 countries that account for 95 percent of world trade and GDP is roughly 7 percent in the manufacturing sector (see table 1, column 6).<sup>2</sup> No wonder that cuts in already low tariff levels do not result in large welfare gains. “Death by Success” would seem an appropriate epitaph for the WTO in the manufacturing sector.

Such a conclusion would be terribly wrong. First, it ignores the situation in agriculture and in services. These two sectors are highly protected and together they represent 75 percent of the GDP of rich and poor countries alike (although in very different proportions). Potential gains from liberalization in these sectors are huge—and industrialists will be among the chief beneficiaries, particularly as consumers of services.

Second, and of much more direct concern to the industrialists, such a conclusion relies on a deeply misplaced perception of the real situation facing the industrial sector itself. Industrialists take for granted the current state of liberalization in manufacturing. It is time for them to wake up and realize, before it is too late, that the current world trade regime in manufacturing is a funabulist walking a tightrope above an abyss. To reach this conclusion

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<sup>2</sup> Table 2 shows that the picture is no different if the tariff averages used are import-weighted or GDP-weighted. All these numbers leave aside three large economies: Algeria (not yet a WTO Member); Russia (still negotiating WTO accession, and imposing an average tariff of 10.5 percent); and Vietnam (still implementing WTO accession, with a targeted average bound tariff of 10.4 percent at the end of the accession period).

one need only look to the real gold mine in the Doha negotiations on industrial products: in the present case, gold means “certainty.”

### **The World as it is – Really**

Today, all the largest economies *apply* mostly moderate or low tariffs in manufacturing. But most of them have *never* made the commitment that they will keep these tariffs at their current levels. For instance, exporters of industrial products to Singapore face an average zero tariff, but Singapore could increase this tariff to 6.3 percent at any time and without providing compensation to its WTO trading partners. Examples abound: average tariffs could surge—again, at any time and with no penalty—from 3.6 to 11 percent in Australia, from 6.6 to 10.2 per cent in Korea, from 6.7 to 35.6 per cent in Indonesia, from 12.5 to 30.8 percent in Brazil, or from 11.5 to 36.2 percent in India (see table 1, columns 5 and 6). To keep things simple, all these examples are expressed in terms of average tariffs over all industrial products. But increases are likely to be higher for those tariffs that remain high—up to 300 percent!—and hence much more devastating for concerned foreign exporters and domestic consumers.

Are such dramatic reversals possible? WTO negotiators (and before them GATT negotiators) conclude agreements in terms of “bound” tariffs. WTO Members can apply tariffs that are lower than the agreed bound tariffs, but the bound tariffs are the only ones that, according to WTO rules, an importing country cannot raise without compensating its affected trading partners. As a result, they are the only ones that deliver the kind of legal certainty that business people cherish so much.

Table 1 illustrates the magnitude of the problem. Out of the 34 largest economies, only *eight* impose their applied tariffs at their bound levels. These eight (Canada, China, the European Union, Hong Kong, Japan, Macao, Taiwan, and the United States) are the only “certain” WTO Members—all the others are potential defaulters.<sup>3</sup>

The fact that these eight economies represent between two-thirds and three-quarters of world GDP (depending upon the exchange-rate used) may seem reassuring. It is not. The “Quad” countries (Canada, the European Union, Japan, and the United States) accounted for roughly

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<sup>3</sup> Ten more countries, all Recently Acceded Members, could be added to these large Members, but altogether they represent less than 0.6 percent of the world trade and 0.3 percent of world GDP (even including Vietnam).

the same share of world GDP in 1980 (using PPP-based exchange rates) or in 1990 (using current exchange rates). In short, China and Taiwan have compensated for the declining weight of the “Quad” countries’ share of world GDP in a rapidly globalizing world. But this does not mean that China and Taiwan are stabilizing the level of certainty of the world trade regime at its 1980 or 1990 level. The high growth of China and Taiwan is both recent and deeply intertwined—and hence very fragile. That will make it hard for these economies to produce the same level of certainty as the other “certain” WTO Members—assuming that such a level is remaining constant. If—when?—crisis strikes in China, nobody really knows what will happen, all the more because China’s political stability is largely based on the government’s capacity to deliver *high growth* and not just any growth.

The 26 other largest economies, whose tariffs are applied at rates below their tariff bindings, are also a source of severe systemic risk. Roughly half a dozen of them could be seen as generating moderate risk since their bound tariffs are merely 4 to 8 percent higher than the corresponding applied tariffs. But these small numbers are deceptive: they conceal huge trade flows that are crucial to our modern economies dominated by goods assembled from many components produced in many countries—with many border-crossings that make even low tariffs costly. The remaining countries individually represent smaller trade flows. But together they make up a substantial part of world trade in industrial goods (roughly 18 percent), exhibit an annual growth rate twice that of the Quad’s, and the risks involved are much larger: their bound industrial tariffs are often 20 to 40 percent higher than their applied tariffs.

The benefits of binding in the Doha Round stem from the elimination of the possibility that the emerging economies—40 percent of the GDP of the rich countries—could increase their tariffs on average by 3.5 times (from roughly 8 to 28 percent for industrial goods, and from roughly 19 to 66 percent for agricultural products) at any time and without providing compensation to their WTO trading partners.

### **Why would it be different today?**

In the late 1920s and early 1930s, the world trading system collapsed precisely because it could not deliver enough “certainty”—indeed, the notion of bound tariffs was created by witnesses to this collapse. However, many may argue that looking at such a distant past is

irrelevant, dismissing the fact that, in the late 1920s, the world trade regime was 65 years old—roughly the same age as ours!<sup>4</sup> Would it really be any “different” today?

Two recent cases shed some disturbing light. In the early 2000s, Turkey was in the midst of a severe economic crisis, raising the prospect of tariff increases as a source of much-needed additional public revenue. However, ultimately Turkey did not raise tariffs because the country had entered into a customs union agreement with the European Union in 1995, agreeing to apply the EU tariff policy, including EU tariff bindings. Should Turkey thus be considered a “certain” WTO Member by proxy? Not until it becomes an EU Member State—and this is a much-debated possibility.<sup>5</sup>

The second case illustrates a much more common—and worrisome—situation. In the mid-1990s, Mexico was hit by one of the worst economic crises it has endured, very soon after the signing of the North American Free Trade Agreement (NAFTA) with the United States and Canada. Once again, this raised the prospect of tariff increases. Mexico decided not to raise its tariffs on imports from Canada and the United States, but to do so on more than 500 goods imported from the rest of the world. In case of a world economic crisis (a slump in the United States or European Union combined with a severe slowdown in China) such a “beggar-most-of-my-neighbors” possibility—exporting uncertainty to most trading partners, while abolishing it for very few others at the price of higher trade distortions domestically—would be a sure recipe for the world-wide and bitter collapse of the global trading system. The recent ban on food exports by 28 countries is ample evidence that a crisis atmosphere pushes governments to take politically expedient but economically unsound actions.

### **The Doha Package: The *Pacificateur***

If adopted, the Doha Round package currently under discussion in Geneva would hugely improve certainty. In the industrial sector, the emerging economies would cut their average bound tariffs to roughly 13-15 percent, with very few tariffs remaining above 20 percent. For almost half of these products, the post-Doha bound tariffs would be lower than the currently

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<sup>4</sup> The fact that many countries have been quick to impose export taxes or restrictions (not banned by the WTO) during the recent food price increases shows the willingness of governments to adopt knee-jerk trade policy measures, even when these measures so obviously hurt their domestic interests.

<sup>5</sup> It is hard to believe that the customs union between the EU and Turkey would last if full EU membership is not offered to Turkey. In the absence of full membership, Turkey would probably ask for (and get) a free trade agreement with the EU, recovering its autonomy in trade policy.

applied tariffs. Because this is the only source of the current estimates of the welfare gains from the Doha negotiations on industrial goods, the estimates reflect only a small part of the overall gains to be had. For the other half, the applied tariffs would remain the same. But the bound tariffs would be cut by a huge amount, 15-18 percentage points on average—roughly 5 times the average cuts in applied tariffs. Such cuts would reduce current transaction costs, generating the “commercial opportunities” that negotiators are asking for and that are not exploited because of fear of sudden changes in countries’ tariffs. They would deliver the certainty so much desired by the industrialists—and with it, the huge welfare gains that are ignored by current estimates of the benefits of the Doha Round.<sup>6</sup>

The Doha Round negotiations in agriculture will have an even stronger “pacifying” impact because the uncertainty is much worse in “agriculture” than in manufacturing (see table 1, columns 9 to 11). Contrary to a widely-held belief, the agriculture negotiations concern processed food products in addition to farm commodities. Moreover, not only would the Doha package in agriculture bind these tariffs at a more moderate level, but it would also bind export subsidies at a very low level and domestic subsidies in agriculture at a level relatively similar to the tariff bindings. Of course, there is the risk of overly-generous “exceptions” to these moves toward liberalization. But clearly, the stronger the support for the Doha Round from the business community, the sounder the exceptions will turn out to be.

Taken together, all these results are very close to what European, U.S., and world businesses have been repeatedly asking for since the early 2000s. Without critical support from the business community, there is a serious risk that trade negotiators will lose control of the WTO talks, with the catastrophic consequences underlined above. Talleyrand, a famous French negotiator, kept saying to an ever more demanding Napoleon “*Votre Majesté, surtout point trop de zèle*” (“Your Majesty, not too much zeal”). Napoleon ignored Talleyrand’s advice. He ended up at Waterloo.

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<sup>6</sup> Economic analysis shows that benefits from tariff cuts are the function of a square of those tariff cuts. This means that the welfare gains associated with cuts in bound tariffs can still be (much) higher than those generated by cuts in applied tariffs, even if one takes into account the fact that a systemic failure of the world trade regime is not a certain event.

**Table 1. The urgent need for consolidating the world trade regime**

WTO Members	Gross Domestic Product			Total imports	Industry				Agriculture			
	billions US\$	billions US\$	Real growth		simple average bound	average applied	average tariff	imports	simple average bound	average applied	average tariff	imports
	[a]	[b]	[c]	[a]	tariff (%)	tariff (%)	water [d]	[a]	tariff (%)	tariff (%)	water [d]	[a]
	1	2	3	4	5	6	7	8	9	10	11	12
<b>The 8 largest "true" WTO Members</b>												
EU27 [e]	14554	12634	2.1	1697	3.9	3.8	0.1	1016	15.1	15.0	0.1	124
United States	13202	13202	2.7	1918	3.3	3.2	0.1	1348	5.0	5.5	-0.5	104
Japan	4340	4131	1.6	580	2.4	2.6	-0.2	297	22.7	22.3	0.4	65
China	2668	10048	9.8	791	9.1	9.1	0.0	579	15.8	15.8	0.0	51
Canada	1251	1140	2.5	358	5.3	3.7	1.6	280	14.5	17.9	-3.4	24
Taiwan	365	n.a.	2.8	203	4.8	4.6	0.2	138	18.4	17.5	0.9	10
Hong Kong	190	267	4.7	336	0.0	0.0	0.0	305	0.0	0.0	0.0	12
Macao	14	20	12.9	5	0.0	0.0	0.0	3	0.0	0.0	0.0	1
<b>All the 8 Members</b>	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]
	78.1	66.8	2.9	67.1	4.1	3.9	0.3	67.1	13.1	13.4	-0.4	62.7
<b>The next 26 largest WTO Members</b>												
Brazil	1068	1708	2.9	96	30.8	12.5	18.3	66	35.5	10.3	25.2	6
India	906	4247	7.3	175	36.2	11.5	24.7	85	114.2	34.4	79.8	7
Korea	888	1152	4.6	309	10.2	6.6	3.6	178	59.3	49.0	10.3	19
Mexico	839	1202	2.2	268	34.9	11.2	23.7	222	44.1	22.1	22.0	19
Australia	768	728	3.1	139	11.0	3.8	7.2	106	3.3	1.3	2.0	8
Turkey	403	662	4.6	140	16.9	4.8	12.1	93	60.1	46.7	13.4	8
Indonesia	364	921	4.9	80	35.6	6.7	28.9	53	47.0	8.6	38.4	7
Norway	311	202	2.2	64	3.1	0.6	2.5	50	135.8	57.8	78.0	5
Saudi Arabia	310	384	3.4	70	10.5	4.7	5.8	56	20.0	7.6	12.4	9
South Africa	255	567	4.1	77	15.7	7.6	8.1	55	40.8	9.2	31.6	4
Argentina	214	618	3.1	34	31.8	12.3	19.5	30	32.6	10.2	22.6	1
Thailand	206	604	5.0	131	25.5	8.2	17.3	87	40.2	22.1	18.1	7
Venezuela	182	203	3.8	34	33.6	12.7	20.9	29	55.8	16.4	39.4	4
Malaysia	149	301	4.7	131	14.9	7.9	7.0	101	76.0	11.7	64.3	9
Chile	146	208	4.2	38	25.0	6.0	19.0	23	26.0	6.0	20.0	3
Colombia	136	363	3.9	26	35.4	11.8	23.6	22	91.9	16.6	75.3	3
Singapore	132	144	4.6	239	6.3	0.0	6.3	175	36.5	0.1	36.4	7
Pakistan	129	406	5.1	30	54.6	13.8	40.8	17	95.6	15.8	79.8	4
Israel	123	179	1.6	50	11.5	5.0	6.5	36	73.3	19.7	53.6	4
Philippines	117	463	4.6	54	23.4	5.8	17.6	40	34.6	9.6	25.0	4
Nigeria	115	169	5.5	22	48.5	11.4	37.1	18	150.0	15.6	134.4	3
Egypt	107	352	4.2	21	27.7	9.2	18.5	10	96.1	66.4	29.7	5
New Zealand	104	110	3.2	26	10.6	3.2	7.4	19	5.7	1.7	4.0	2
Peru	93	188	4.7	15	30.0	9.7	20.3	10	30.8	13.6	17.2	2
Kuwait	81	67	5.5	16	100.0	4.7	95.3	13	100.0	4.0	96.0	2
Bangladesh	62	320	5.6	16	34.4	14.2	20.2	10	192.0	16.9	175.1	3
<b>All the 26 Members</b>	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]
	17.5	26.5	4.1	26.2	27.6	7.9	19.7	27.1	65.8	19.0	46.8	24.8
<b>Other Members</b>	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]	[f]
	2.0	3.5	3.8	4.5	34.3	9.9	24.4	4.3	62.3	17.0	45.2	8.0

Source: WTO Secretariat, Trade Profiles, WTO website (<http://www.wto.org>), April 2008. Author's computations.

Notes: [a] in billions of US\$ at current exchange rates (countries are classified by declining GDP at current exchange rates).  
 [b] in billions of US\$ at purchasing-power-parity exchange rates.  
 [c] annual growth rate of the real GDP observed for the 2000-2006 period.  
 [d] the "tariff water" (in percentage) is the difference between the average bound tariff and the average applied tariff.  
 [e] EU27 is counted as one WTO Member.  
 [f] in percent of the world total.

**Table 2. Additional estimates of tariff averages (%)**

WTO Members	Import-weighted tariff averages				current GDP-weighted tariff averages				GDP(PPP)-weighted tariff averages			
	industry		agriculture		industry		agriculture		industry		agriculture	
	bound	applied	bound	applied	bound	applied	bound	applied	bound	applied	bound	applied
<b>The 8 largest</b>	3.6	3.4	11.4	11.8	3.9	3.8	12.3	12.5	4.8	4.7	12.7	12.9
<b>The 26 largest</b>	21.5	7.1	60.2	22.8	24.9	8.3	57.0	22.1	28.4	9.4	68.9	23.6
<b>Other Members</b>	26.5	9.6	49.7	19.8	30.1	9.7	51.0	20.0	30.4	11.2	52.0	21.8

Source: see Table 1.