

RETHINKING GLOBALIZATION

RIISING TO THE TWENTY-FIRST CENTURY CHALLENGES OF GLOBALIZATION

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- GATT performed well for much of the 20th century
 - By the time the results of the Uruguay Round had been fully implemented, average tariffs on industrial goods had been reduced to below 4% and quantitative restrictions were largely eliminated
- But challenges to the WTO's position at the top of the world trading system are piling up
 - China's 2001 accession to the WTO
 - The rise of large emerging and developing economies in the world trading system more generally
 - The rise of offshoring and global supply chains
 - More recently the increasing importance of digital trade, and the increasing urgency of addressing climate change
- Meanwhile
 - GATT's shallow approach to integration has been eclipsed by deeper forms of integration
 - And we are now witnessing a strong backlash against globalization
- Do we need a new world trading system to meet the challenges of the 21st century?

Approach and Main Takeaways

- To answer this question, I adopt a basic premise from the research on the economics of trade agreements
 - The design of a trade agreement should reflect its purpose, the “problem” it is supposed to “solve”
 - I consider the purpose of a trade agreement in a world stripped of the 21st century challenges enumerated above
 - I describe how the fundamental design features of GATT were well-equipped to serve this purpose
 - and I argue that this harmony between purpose and design can help account for the success of the GATT/WTO in the 20th century
 - I then ask: Do any of these 21st century challenges change the purpose of a trade agreement?
 - The answers can illuminate the nature of the challenges faced by the WTO and the world trading system
 - I argue that the logic of GATT's design transcends many of the current challenges faced by the WTO
- ⇒ The best advice for designing a world trading system for the 21st century may not be “Move fast and break things,” but rather Keep Calm and Carry On

A key starting point: Purpose

- The WTO's legitimacy is not built on the case for free trade
 - rather, it's built on the case for internalizing the international externalities emanating from unilateral trade policy choices
 - if these externalities can be internalized by each country's policy makers, the trade policy choices that countries make will be efficient as judged by their own policy preferences
- Spoiler Alert
 - If the GATT/WTO was well-designed to handle the international policy externalities in the 20th century,
 - and if the 21st century challenges faced by the WTO do not change the nature of these externalities,
 - then the WTO will be well-designed to handle the challenges of the 21st century
- In a broad set of environments that have been studied by economists, the nature of the international policy externality is the same
 - countries that have market power over international prices (their "terms of trade" with the world) can shift a portion of the costs of their trade restrictions onto trading partners
 - this cost-shifting leads to a problem: acting on their own, countries tend to choose overly protective policies relative to efficient policies as judged by their own policy preferences

⇒ The purpose of a trade agreement according to the TOT theory:

- To eliminate market power/cost-shifting considerations from unilateral tariff choices and expand market access to efficient levels,
- and thereby to provide an escape from a terms-of-trade driven Prisoner's Dilemma (Meade, 1955)

“[T]he restoration of greater freedom for international trade and factor movements can be made meaningful only by means of international agreements which cut rather deeply into domestic economic arrangements. One cannot hope to see the abandonment of protective devices except in the framework of all-round international agreement, since unilateral action is quite likely to cause the free-trade country to lose more from a deterioration in its terms of trade than it gains from the expansion of trade. But as soon as any attempt is made to limit protective devices, a whole host of domestic economic arrangements must be brought under examination. Tariffs and quantitative import restrictions are not the only means for protecting domestic industries. Subsidies, domestic taxes, domestic price and quantity controls, nationalization schemes – all can be used for similar purposes. Yet all of these instruments may be perfectly legitimate instruments of policy for the attainment of certain other perfectly legitimate objectives. ... If a more liberal international economy is to be established by international agreement, one must search for a working compromise between the need effectively to curb protective devices and the need to give national governments freedom to adopt effective domestic economic policies for the attainment of legitimate domestic objectives.”

– The Theory of International Economic Policy, Volume Two: Trade and Welfare, by J. E. Meade. Oxford University Press, London: 1955, p 570.

The World Trading System of the Twentieth Century: Purpose

- Holds under a wide array of government objectives that include political economy and distributional concerns, and leads to an expansion of market access (Bagwell and Staiger, 1999, 2002)
- Holds in a many-country perfectly competitive world provided that tariffs conform to MFN (Bagwell and Staiger, 1999, 2002), and holds for general equilibrium or partial equilibrium environments (Bagwell and Staiger, 2001a)
- Holds for trade in goods and trade in services when governments have access to additional domestic regulatory/tax instruments (Bagwell and Staiger, 2001b, Staiger and Sykes, 2011, 2021)
- Holds in models of Cournot or monopolistic competition with homogeneous firms (Bagwell and Staiger, 2002 chapter 9, 2012a,b, 2015) and in models of monopolistic competition with heterogeneous firms (Bagwell and Lee, 2020, Campolmi, Fadinger and Forlati, 2020, and Costinot, Rodriguez-Clare and Werning, 2016, 2020)
- Does require a complete set of trade tax instruments, but not a complete set of policy instruments more generally (Ossa, 2011, Bagwell and Staiger, 2012, 2015, 2016)
- Does require the absence of international non-pecuniary externalities associated with policy choices

The World Trading System of the Twentieth Century: Design

- The basic architecture of GATT seems well designed to serve this purpose with a minimal sacrifice of national sovereignty (Bagwell and Staiger, 1999, 2001b, 2002, 2018b)
 - the international externality is pecuniary, and the design of GATT exploits this feature
 - The GATT pillars of **MFN** and **reciprocity** simplify the tariff bargaining problem
 - the MFN rule (nondiscrimination) alters the structure of the international externality, extending the simplicity of the 2-country terms-of-trade externality to a many country world
 - reciprocity (a proportionate response to the tariff changes of trading partners) helps to stabilize the terms of trade, and directs the focus of bargaining away from terms-of-trade (zero sum) movements
 - And the economic logic of **shallow integration** is sound
 - a tariff is the perfect instrument for manipulating the terms of trade
- ⇒ According to the TOT theory, noncooperative (Nash) tariffs are inefficiently high, but by the targeting principle Nash non-tariff policies are efficient, conditional on Nash trade volume (Meade, 1955)

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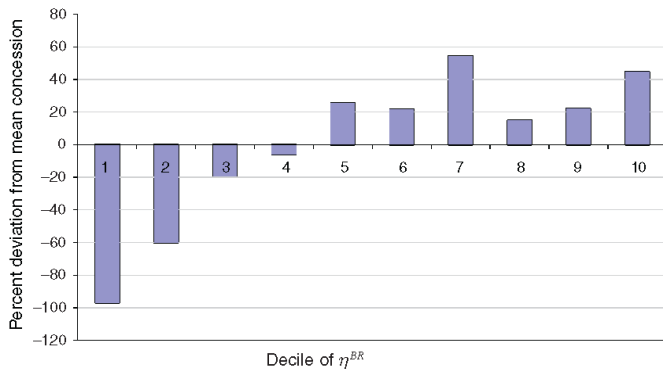
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 - ⇒ According to the TOT theory, noncooperative (Nash) tariffs are inefficiently high, but by the targeting principle Nash non-tariff policies are efficient, conditional on Nash trade volume (Meade, 1955)
- In theory, a trade agreement could focus on lowering tariffs as a means of expanding market access (“conditions of competition”) and trade volumes to efficient levels
 - And put in place various “market access preservation rules” that apply to non-tariff policies and prevent governments from using non-tariff policies to back-slide on their market access commitments
- Under GATT’s approach, countries negotiate tariff bindings to make market access commitments, and GATT Articles provide the accompanying market access preservation rules
 - For example, Petersmann’s (1997, p. 136) observes that “...the function of most GATT rules (such as Articles I-III and XI) is to establish conditions of competition and to protect trading opportunities...”

- Many papers provide evidence that GATT/WTO design features have helped governments achieve this purpose
 - Broda, Limao and Weinstein (2008), Bagwell and Staiger (2011), Bown and Crowley (2013), Ludema and Mayda (2013), Nicita, Olarreago and Silva (2014), Beshkar, Bond and Rho (2015), Beshkar and Bond (2017), Bagwell, Staiger and Yurukoglu (2020, 2021)
- Here I highlight three:
 - Bagwell and Staiger (2011)
 - Bagwell, Staiger and Yurukoglu (2020)
 - Bagwell, Staiger and Yurukoglu (2021)

What Do Trade Negotiators Negotiate About?

- Bagwell and Staiger (2011) focus on 16 countries that negotiated accession to the WTO after its creation in 1995 and ask whether their agreed tariff cuts reflect the removal of market power considerations from their unilateral tariff choices
- If so, their agreed tariff cuts should be increasing in their measured market power η^{BR}



- I next describe results from Bagwell, Staiger and Yurukoglu (2020a)
- Many GATT rounds utilized bilateral tariff bargaining, where requests for market access were matched by reciprocal offers, and with the results multilateralized according to MFN
 - According to the terms-of-trade theory, this approach to tariff bargaining can eliminate strategic bargaining behavior (Bagwell and Staiger, 2018a)
- The absence of strategic bargaining behavior is seen by GATT practitioners and legal scholars as a hallmark of the tariff bargaining that occurred in the early GATT rounds and as distinguishing GATT tariff bargaining from the tariff bargaining that preceded it
 - *... Their requests cannot be higher than their offers and negotiations start from this maximum position: if all requests are granted all the offers will be fulfilled. Similarly all other contracting parties are likely to make offers which match the requests they have made. As some of the requests are rejected, some of the offers are withdrawn. This procedure has been raised to a Gatt principle and is not laid down by any rule. It is a convention but one which creates a much better negotiating climate than the opposite trend which was a feature of the classical bilateral negotiations. Then, everyone put forward very low offers with the intention of increasing gradually if the bargaining proved profitable. A country never knew, however, when it had reached the maximum its partner was willing to concede. Curzon (1966, p. 74)*

Multilateral Trade Bargaining

- Curzon describes a tariff bargaining forum in which there is no point in making lowball initial offers, because governments are expecting non-strategic behavior from their bargaining partners and such offers would simply be taken at face value
- For GATT oldtimers
 - The initial offer made by a country ("sales") reduced tariffs to 0.808 of the existing tariff level while the final offer made reduced tariffs to 0.806 of the existing tariff level
 - The initial offer received by a country ("purchases") reduced tariffs to 0.817 of the existing tariff level while the final offer received reduced tariffs to 0.802 of the existing tariff level

		Sales			Purchases		
		Ad Val	Specific	All	Ad Val	Specific	All
		Country-Specific					
Initial request over existing tariff	Mean	0.543	0.577	0.554	0.512	0.582	0.539
	SD	0.235	0.306	0.260	0.257	0.321	0.286
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	17681	7971	25652	15621	9911	25532
Initial offer over existing tariff	Mean	0.804	0.817	0.808	0.796	0.845	0.817
	SD	0.195	0.233	0.208	0.213	0.218	0.216
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	8387	3577	11964	6578	5008	11586
Final agreed concession over existing tariff	Mean	0.797	0.827	0.806	0.773	0.831	0.802
	SD	0.200	0.235	0.212	0.211	0.240	0.228
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	5603	2394	7997	3384	3341	6725

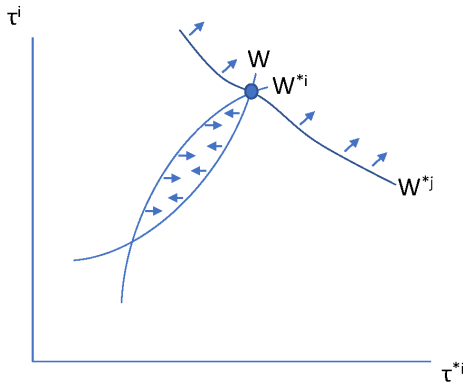
Multilateral Trade Bargaining

- Several newcomers to GATT unaware of this new technique and starting with low offers found that in the course of negotiations they were unable to reach the level of requests they aimed for. Their initially low offers were taken as proof of their intentions and they either had to go home with a tariff higher than expected or had to increase their offers in the course of the negotiations. Curzon (1966, p. 74)
- GATT newcomers
 - The initial offer made by a country ("sales") reduced tariffs to 0.855 of the existing tariff level while the final offer made reduced tariffs to 0.819 of the existing tariff level
 - The initial offer received by a country ("purchases") reduced tariffs to 0.833 of the existing tariff level while the final offer received reduced tariffs to 0.820 of the existing tariff level

		Sales			Purchases		
		Ad Val	Specific	All	Ad Val	Specific	All
Country-Specific							
Initial request over existing tariff	Mean	0.471	0.611	0.544	0.571	0.617	0.585
	SD	0.294	0.327	0.319	0.223	0.290	0.246
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	4306	4696	9002	6366	2756	9122
Initial offer over existing tariff	Mean	0.827	0.870	0.855	0.829	0.840	0.833
	SD	0.229	0.203	0.213	0.179	0.225	0.197
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	1798	3445	5243	3607	2014	5621
Final agreed concession over existing tariff	Mean	0.725	0.846	0.819	0.807	0.849	0.820
	SD	0.179	0.241	0.234	0.183	0.232	0.201
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	668	2271	2939	2887	1324	4211

Quantitative Analysis of Multiparty Tariff Negotiations

- And finally, I consider what we know about tariff bargaining in the absence of GATT rules
- I describe results from Bagwell, Staiger and Yurukoglu (2021) who ask: Could GATT tariff negotiations have performed better if MFN had been abandoned?
 - MFN can create a free rider problem in bilateral tariff bargaining settings (a positive 3rd-party externality) that keeps countries from liberalizing all the way to the efficiency frontier
 - But in the absence of MFN and beginning from any point on the efficiency frontier, there is an incentive for each bilateral pair of countries to over-liberalize on a discriminatory basis and steal surplus from third countries (a negative 3rd-party externality)



Quantitative Analysis of Multiparty Tariff Negotiations

- Which 3rd-party externality is more damaging?

TABLE VII
ESTIMATED URUGUAY ROUND AND COUNTERFACTUAL OUTCOMES^a

	Estimated Bargaining Parameters		All 0.5 Bargaining Parameters	
	MFN	No MFN	MFN	No MFN
	Δ% 1990	Δ% 1990	Δ% 1990	Δ% 1990
Δ Mean Tariff	-30.22%	-28.85%	-29.22%	-28.59%
Δ Trade Wgt'd Mean Tariff	-19.54%	-130.36%	-19.11%	-131.27%
Country Welfare				
US	0.01%	-0.13%	0.02%	0.11%
EU	0.02%	0.06%	0.03%	0.08%
Japan	0.10%	0.32%	0.06%	-0.24%
South Korea	0.17%	0.15%	0.32%	0.04%
Australia	0.06%	-1.71%	0.07%	0.18%
Canada	0.02%	-0.49%	0.02%	-0.59%
Africa NES	0.03%	-0.08%	0.02%	-0.09%
America NES	0.02%	-0.05%	0.02%	-0.04%
Asia NES	0.15%	-0.37%	0.17%	-0.33%
Europe NES	0.02%	-0.12%	0.02%	-0.16%
MENA NES	0.01%	-0.28%	0.00%	-0.49%
Mean	0.10%	-0.21%	0.11%	-0.19%
World Real Income	0.06%	-0.02%	0.06%	-0.07%

^aNotes: Each column represents changes in the row relative to the pre-Uruguay tariff levels. Tariff averages are computed among nonagriculture sectors for the bargaining countries. The mean across countries is weighted by population.

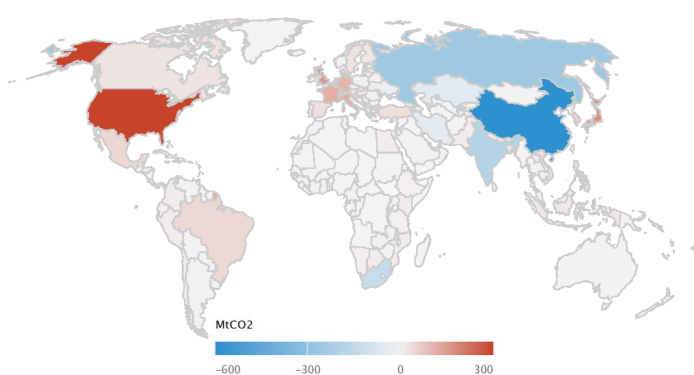
Meeting the Challenges of the Twenty-First Century

- The design of a trade agreement should reflect its purpose, the “problem” it is supposed to “solve”
- In a world stripped of its 21st century challenges the purpose of a trade agreement is to help governments escape from a terms-of-trade driven Prisoner's Dilemma
 - I have described how the fundamental design features of GATT are well-equipped to serve this purpose
 - And I have argued that this harmony between purpose and design can help account for the success of the GATT/WTO in the 20th century
- I now ask: Is the purpose of a trade agreement different in the 21st century?
 - If so, then fundamental changes to the design of the world trading system may be needed
 - If not, then the fundamental design of the GATT/WTO should be adequate to meet the challenges of the 21st century
- Below I consider six of globalization's twenty-first century challenges

- **Challenge 1:** *How to manage existing market access commitments when confronting new nontrade problems such as climate change that demand major policy initiatives with market access implications of their own*
 - The challenge arises mainly when some countries impose a carbon tax and others do not
 - A tax on the *production* of carbon creates more *favorable* market access conditions into the tax-imposing country for those countries that do not impose the tax, *raising* the world price of carbon-intensive goods and potentially causing *carbon leakage*

The Prospect of Carbon Leakage

CO2 imports and exports from trade, 2014



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- A tax on the *consumption* of carbon triggers *harmful* market access consequences into the tax imposing country for those countries that do not impose the tax, *lowering* the world price of carbon-intensive goods and avoiding carbon leakage, instead causing other countries to reduce their production of carbon-intensive goods
- A carbon border adjustment could be combined with a tax on the production of carbon and set at a level designed to turn the carbon production tax into a carbon consumption tax (EU CBAM), thereby addressing the carbon leakage problem that arises with a tax on the production of carbon alone
- But that's not the only possible design of a carbon border adjustment ...
- A middle-ground carbon border adjustment would *conform to MFN* and be set to *neutralize* the market access consequences of the carbon production tax, addressing the carbon leakage problem without triggering harmful market access consequences

- **Challenge 2:** *How to prepare for the rise of digital trade*

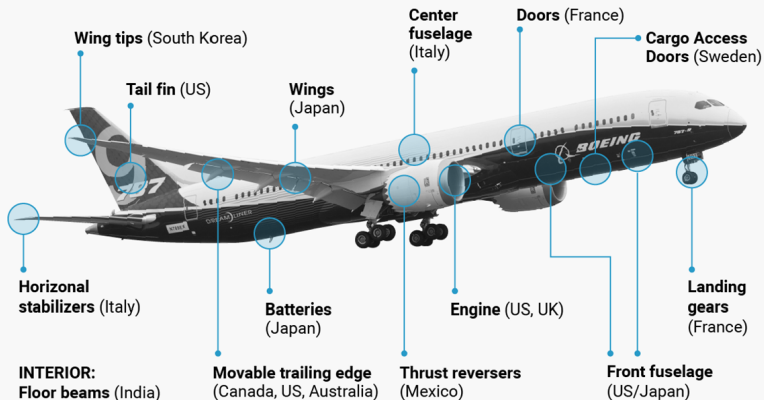
- The rise of digital trade creates the potential for new shocks to existing market access commitments
- Requires flexibility in tariff commitments to stabilize market access/trade volumes in the presence of these and other shocks (GATT/WTO better situated to provide this flexibility than PTAs)
- But digital trade also blurs the distinction between goods and services, and this spells trouble for design of GATS v GATT
- Could redesign GATS to be more like GATT...

- **Challenge 3:** *How to handle the extended reach of arguments for industrial policy*

- Arguments for industrial policy to maintain industries deemed critical for health or national security or with strong positive externalities are not new
- But one thing that is new is the reach of these arguments due to the rise of offshoring

The Rise of Offshoring and Global Supply Chains

THE GLOBAL ORIGINS OF THE BOEING DREAMLINER



SOURCE: Boeing; Reuters

BUSINESS INSIDER

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- But one thing that is new is the reach of these arguments due to the rise of offshoring
- Where technological/legal hurdles once provided “natural protection” all the way up the supply chain of an industry deemed critical, now the global factory floor model of production requires that every link in the supply chain of a critical industry be examined for possible “reshoring”
- So where once a single industrial policy might have sufficed, now a suite of industrial policies may be required to achieve the same goal (e.g., vaccine production for pandemic response, lithium-ion batteries for EVs)
- Also new is (i) the greater credibility of national security exceptions when important WTO members are engaged in cold/hot war, and (ii) the microchip’s “dual use” property combined with its ubiquity in the digital age (as compared to e.g., ammonia for fertilizer/chemical weapons in an earlier age)
- But to handle international *pecuniary* externalities, the goal of multilateral rules to discipline industrial policy choices should always be the same: to allow countries to make their own decisions while preventing those decisions from being driven by the ability to shift some of the costs onto others...

- **Challenge 4:** *How to successfully integrate a non-market economy such as China's into the rules-based multilateral trading system*
 - It's been done before, most notably with Poland in 1967, but China is so much bigger
 - Still, the purpose of a trade agreement – to internalize the international pecuniary externalities of unilaterally policy choices – does not change in the presence of a non-market economy, and facilitating secure, reciprocal market access commitments among members remains the ultimate goal
 - The question is how to allow China to make secure non-discriminatory market access commitments and abide by the reciprocity norm ...
- Poland's Draft Protocol of Accession to GATT (1967)

ANNEX B

Draft Schedule LXV - Poland

1. Subject to paragraph 2 below, Poland shall, with effect from the date of this Protocol, undertake to increase the total value of its imports from the territories of contracting parties by not less than 7 per cent per annum.
2. On 1 January 1971 and thereafter on the date specified in paragraph 1 of Article XXVIII of the General Agreement Poland may, by negotiation and agreement with the CONTRACTING PARTIES, modify its commitments under paragraph 1 above. Should this negotiation not lead to agreement between Poland and the CONTRACTING PARTIES, Poland, shall, nevertheless, be free to modify this commitment. Contracting parties shall then be free to modify equivalent commitments.

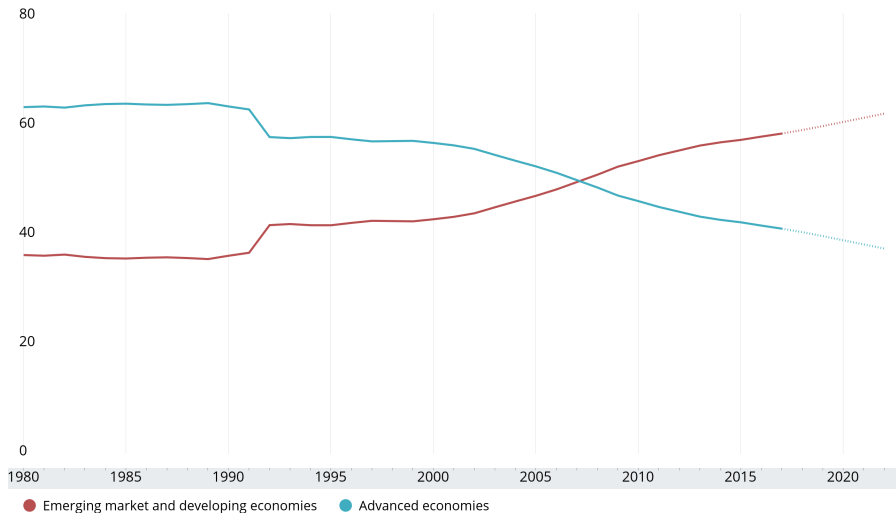
- **Challenge 5:** *How to address the unfinished business of the Doha Round*

- A fundamental objective of the Doha Round was to improve the trading prospects of developing countries

The Rise of Emerging and Developing Economies

IMF DataMapper

GDP based on PPP, share of world (Percent of World)



©IMF, 2017, Source: World Economic Outlook (October 2017)

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- A fundamental objective of the Doha Round was to improve the trading prospects of developing countries
- The asymmetries between the currently low industrialized-country tariffs on manufactured goods, resulting from decades of GATT reciprocal tariff liberalization negotiated by industrialized countries, and the still high emerging/developing-country tariffs, has led to a “latecomers problem”

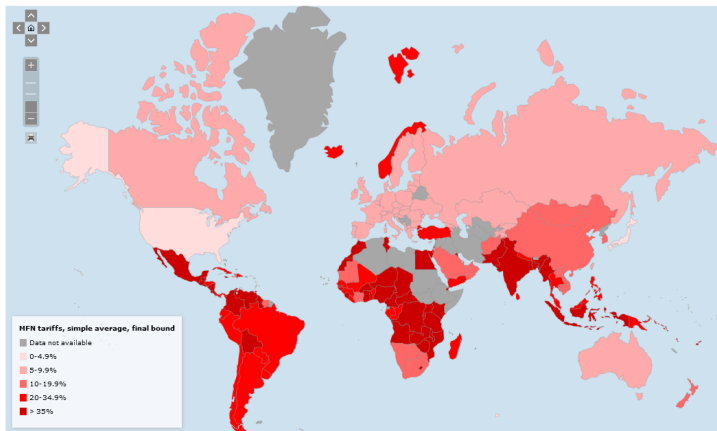
Tariff Asymmetries across Developing/Emerging and Industrialized Economies

MFN tariffs, simple average, final bound

[Help with indicators and symbols](#)

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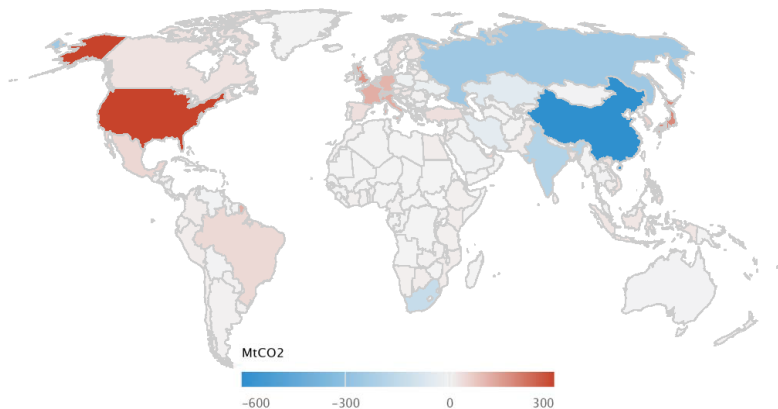
Note: The content of the maps is updated in October every year, at the same time as the WTO Trade and Tariff Profiles.

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- The latecomers problem reflects a tension between (i) large tariff asymmetries across developing/emerging economies and industrialized countries and (ii) negotiating tariff cuts under the GATT/WTO reciprocity norm, and this tension must be addressed if a key objective of the Doha Round is to be achieved
- Industrialized countries could agree to implement carbon taxes (without CBAs), and developing/emerging economies could agree to reciprocate the market access consequences of these carbon taxes by reducing their own tariffs, and the dual goals of addressing climate change and the latecomers problem could be achieved

The Pattern of Carbon Trade

CO2 imports and exports from trade, 2014



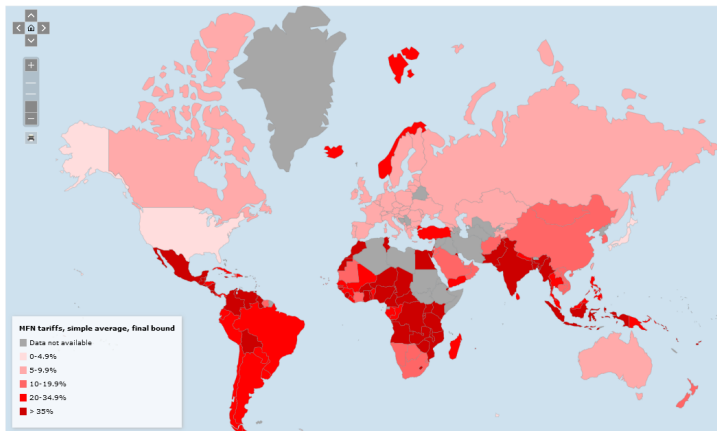
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- How to handle carbon leakage...

- **Challenge 6:** *Can the rules-based multilateral system survive?*

- A rules-based system can enhance efficiency in achieving cooperative trade policy outcomes, in part by constraining the bargaining power of the most powerful countries and thereby encouraging participation of weaker countries
- But support for a rules-based system from the most powerful countries may diminish if their hegemonic status diminishes
- This may describe what is happening in the United States
- Does the rules-based multilateral trading system need a(nother) hegemon to survive?...

Rethinking Globalization for the Twenty-First Century

- I have argued that **the terms-of-trade theory of trade agreements** provides a compelling framework for understanding the success of GATT in the 20th century
 - I have argued that according to this understanding the logic of **GATT's design transcends many of the current challenges faced by the WTO**
 - More broadly, two cross-cutting themes that emerge from the terms-of-trade theory of trade agreements are worth emphasizing for the world trading system of the 21st century
 - **Trade agreements that lack deep-integration provisions are not necessarily “weak” agreements**; and by the same token, those trade agreements that contain the most developed deep-integration provisions should not necessarily be seen as the “gold standard”
 - Where the terms-of-trade theory applies the opposite may be closer to the truth, as with shallow-integration agreements countries might attain efficient policies without sacrificing national sovereignty
 - Viewed from this perspective, the fact that the WTO lags behind various regional initiatives to deepen the negotiated commitments of its member governments may be a virtue rather than a shortcoming
 - It could be argued that **the primary task for the GATT/WTO has shifted**, away from helping governments traverse *to* the efficiency frontier and toward providing them with the flexibility they need to remain *on* the frontier in the face of various shocks to the world trading system
 - For this era the capabilities of countries to rebalance and renegotiate their commitments within the GATT/WTO framework is likely to become paramount to the WTO's success
 - In principle the WTO is as well-equipped for this second task as GATT proved to be for the first
- ⇒ The best advice for designing a world trading system for the 21st century may not be “Move fast and break things,” but rather ...

