

WEEKLY ECONOMIC COMMENTARY

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Without traffic rules, movement on the world’s roads, rails and ports would be chaotic. In a similar way, global trade would be disorderly in the absence of the World Trade Organization (WTO), which has set the traffic rules of the global trading system for more than twenty years.

But amid rising nationalism and protectionism, multilateral organizations like the International Monetary Fund (IMF) are facing an uncertain future. Hence, it is not surprising to see the WTO fighting to sustain its mandate. If the WTO loses this battle, the resulting chaos in the trade arena could be damaging to the world economy.

The WTO was established in 1995, succeeding the General Agreement on Tariffs and Trade that was first set in 1947. The WTO aims to open trade for the benefit of all, without any discrimination. All members abide by the most-favored-nation clause, which forbids preferential treatment to local goods or undue protection of local firms. The WTO defines the rules of trade between countries, acts as a forum for negotiating trade pacts, settles trade disputes and supports the interests of developing economies.

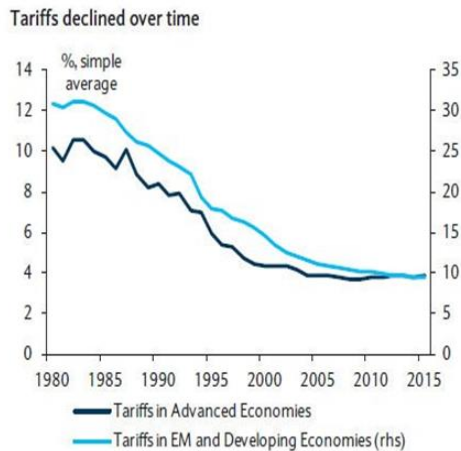
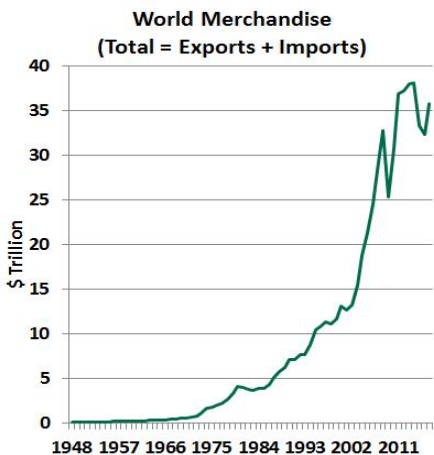
Most of the funding for the WTO’s annual budget comes directly from member contributions using a formula based on each member’s share of international trade. The U.S. is the largest contributor (11.4%), followed by China (9.8%). Combined, European Union (EU) members represent 33.6% of the WTO’s total funding. But this doesn’t translate to voting power. Unlike the IMF, the WTO is a member-driven body, run by its 164 member governments with a consensus-driven decision-making structure. Reaching that consensus has become increasingly difficult in the current environment.

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Sources: WTO, IMF

All WTO members, irrespective of size or the status of their economies, agree to a trade

dispute mechanism to avoid unilateral responses to differences and potential trade conflicts. This is intended as a defense against capricious tariffs, quotas, or other ungrounded restrictions. But the dispute settlement process entails several steps that can last up to 15 months (with appeal). And the WTO lacks the ability to impose penalties, which can limit its authority.

The first stage of dispute resolution involves consultation. If consultations fail, a panel chosen by the WTO’s Dispute Settlement Body (DSB) hears the case; the panel’s recommendations, if not overturned on appeal, must be implemented by the offending country. If the defendant doesn’t comply, it must compensate the plaintiff. In case of no agreement on compensation, the DSB authorizes targeted retaliatory measures against the defendant, whether in the form of blocking imports or raising tariffs.

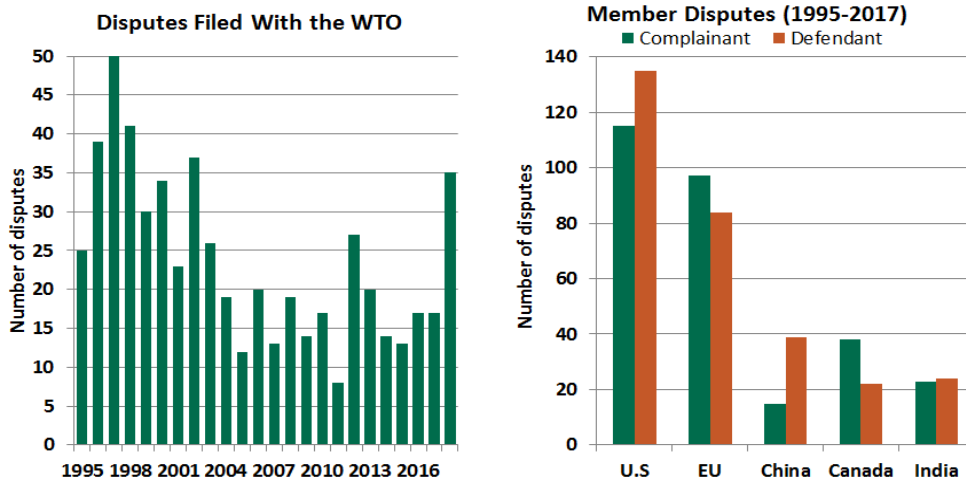
Since its inception, 570 disputes have been filed with the WTO. Most have been settled in consultations or by agreement before advancing to litigation. The WTO has not only helped reduce trade barriers but has also created a dispute resolution mechanism that, for several years, had kept the threat of trade wars at bay.

But the WTO’s caseload has grown substantially since the 2008 financial crisis, and progress toward reaching settlements has been slow. At present, there are major disagreements between WTO members over agricultural subsidies, intellectual property rights and global e-commerce. The struggle to create consensus may explain the move toward separate bilateral or regional free trade agreements.

Interestingly, the United States is the country that files the most WTO complaints, and is named most often as a defendant. While this could be a product of the sheer size of the U.S. economy, it also suggests that the U.S. does not always practice fully fair trade.

China became the 143rd member of the WTO on December 11, 2001. Negotiations were lengthy, requiring China to open and liberalize its economy and create a more predictable atmosphere for trade and foreign investment. China’s commitments included providing non-discriminatory treatment to members, eliminating preferential treatment of goods for domestic consumption and ceasing the use of price control measures that protect local industries or service providers.

The WTO has lost its ability to broker meaningful agreements.



However, over the subsequent years, China has become an active party to WTO disputes, both as a complainant and defendant. China’s continued support for domestic industries, its restrictions on

imports and its alleged appropriation of intellectual property have been focal points.

The Obama administration relied on the WTO process to challenge Chinese measures. From 2009 to 2017, the U.S. filed 25 enforcement complaints at the WTO, more than any other nation over that time period. Sixteen of these claims were against China. The WTO favored the U.S. in seven of these cases related to limits on China's agriculture, aircraft subsidies and steel import duties.

Today, however, the U.S. seems more willing to react unilaterally and pay less heed to WTO standards. Over the past two years, the White House has implemented a long series of tariffs using national security grounds as justification. America is not alone in going it alone: last year, India blocked a series of WTO initiatives after its food security program was not granted a permanent waiver from WTO rules. Though India eventually backed down, moves like these have led to a lack of progress on important agreements.

It almost seems that, instead of working within its dictates, countries are now daring the WTO to react. Unanimity was a pillar of WTO deliberations, but it has become a liability in the rising anti-trade wave.

A weakened WTO will lead to more trading blocs, most likely led by major powers that will use them as political weapons to reward allies and twist competitors' arms. Smaller or less developed nations, whose interests are currently protected by their status as WTO members, should be particularly concerned about the declining importance of the current multilateral trading system.

The WTO may need to reform its governance and its approaches to better fit today's international commerce. But we can't abandon current traffic rules as we await new ones. The world needs a trade cop with powers to issue tickets.

Beyond Tariffs

"I'm shocked—Shocked!—to find that gambling is going on in here!" exclaims the corrupt Captain Louis Renault in the 1942 classic *Casablanca* as he shuts down Rick's Café Américain. Renault, of course, was a regular patron and participant in games of chance. But when he needed a reason to change direction, the law was a useful ruse.

Rising trade tensions are forcing governments to reconsider their how to enforce their laws. The vigor of this enforcement is a subtle but important element of trade policy, which has been tightening over the past several years.

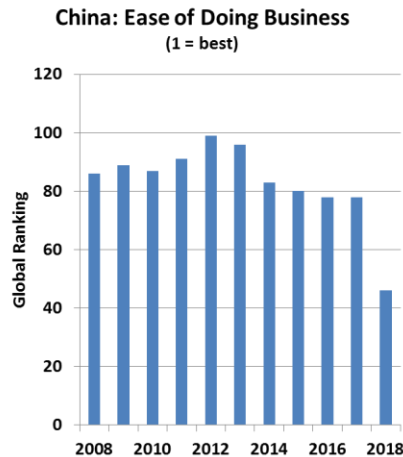
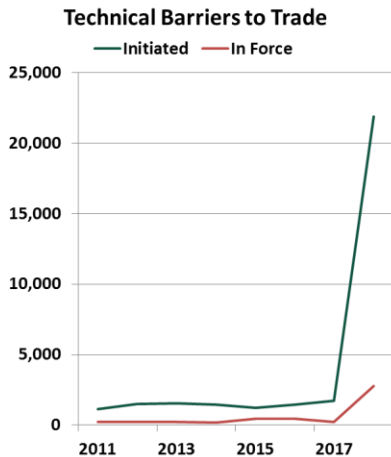
To date, the most prominent trade actions have been the impositions of tariffs by the United States. Many U.S. trading partners have retaliated with import tariffs of their own, but there are limits to this approach. American imports from China equate to about four times the total of its exports to China. China's threatened retaliation of like-for-like tariffs is already reaching its limit.

Aggrieved trading partners have other weapons at their disposal. China's government is involved in a wide range of economic decisions involving investments, construction and hiring. In the past year, the World Bank rated China #46 in its Ease of Doing Business assessment, out of 190 countries surveyed. Though a substantial improvement, it still lags most developed markets. The bureaucracy within China's government gives it a bevy of regulations to selectively enforce.

Inbound shipments must be inspected and duties paid before any cargo can be unloaded. In vessels laden with thousands of cargo containers, close assessments would likely lead to more delays and rejections. The burdens can lead to real losses. Perishable goods, including the hundreds of millions of pounds of pork shipped from the U.S. to China each year, could spoil in the

The WTO's consensus-driven model has become a liability.

harbor. Though evidence is anecdotal and hard to broadly measure, it appears China has already started using some of these tactics against U.S.-flagged vessels, whether to deliberately send a signal to the U.S. or due to simple uncertainty about how to enforce new trade restrictions.



Sources: WTO, World Bank

Tariffs are just one way to discourage imports.

A country can take other actions to raise costs for foreign firms. Participating in financial markets requires certifications that can be slowed. Building a factory requires permits that can be elusive. Hiring workers can be subject to labor requirements that can be tightened. Merger and acquisition deals are subject to government approvals that can be withheld.

Specific laws can give a country cover for trade enforcement that would fall below the WTO’s radar. China has a set of cybersecurity laws that are ripe for strategic exploitation. Imported technologies are subject to six different reviews conducted by different agencies. The reviews are “black box” processes, in which the inspector need not justify its results. A strict reading of an ambiguous law could create years of delays, and proprietary technologies are revealed during the inspection that creates further risk of the theft of intellectual property.

Ideally, these business-hostile actions should be used sparingly. A culture of delays would impair a country’s reputation as a business destination and give foundation for a claim to be heard at the WTO. These tactics would be better employed on companies with an established presence in the country, for which switching costs would be high. Larger firms are more tempting targets, as they carry more political clout in their home countries.

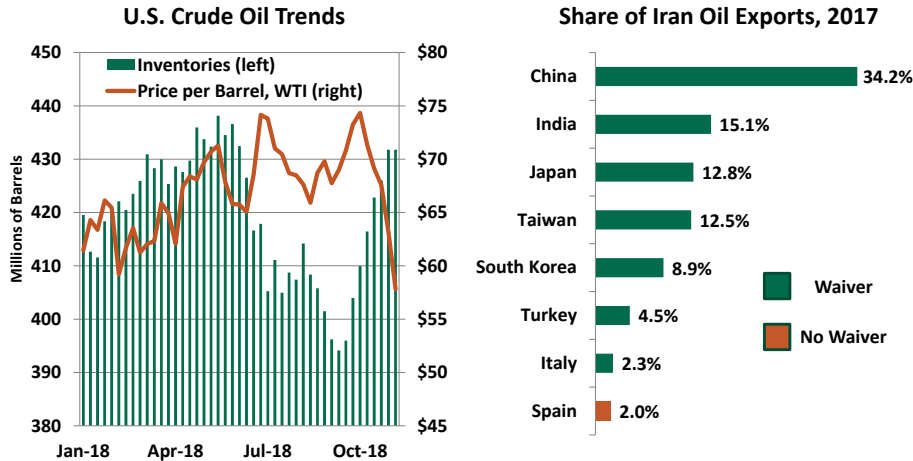
In general, selective enforcement can be a frustrating but effective way of making a point. After a few days of investigation, Rick’s Café was ultimately allowed to reopen for business. Let’s hope the world’s trade negotiators reach the same outcome.

Opening the Spigot

Last month, we discussed the ramifications of rapidly increasing oil prices, which were threatening motorists, emerging markets and the rate of inflation. Since then, crude has experienced an unexpected slump; prices for both Brent and West Texas grades have fallen by more than 20% in the space of just a few weeks.

Booming oil output in the United States is one reason for the reversal. Higher prices promote greater supply, and technology has reduced the lag time between one and the other. (Some in the

industry refer to oil as “a spigot business.”) U.S. crude oil production reached an all-time record level last week; Russia and Saudi Arabia have also been increasing their output.



Sources: Bloomberg, DOE, UNCTAD

A second is the announcement from the U.S. State Department that most of Iran’s export clients would be allowed to continue purchasing oil from Iran on a limited basis. Iran was the fifth-largest producer of crude in the world last year; its customers have been threatened with a loss of access to U.S. payment systems if they continue doing business with Tehran. The exemptions will allow Iranian sales to continue, albeit at a reduced level.

The exemptions are set to expire in six months. They could be renewed, of course, but one senses that they provide Washington with another bargaining chip in the ongoing trade discussions with Beijing. China is, by far, the largest consumer of Iranian oil.

The sudden and sharp decline in prices will once again create dissonance within the Organization of Petroleum Exporting Countries (OPEC) and Russia. Producers have divergent levels of fiscal urgency; while some need cash right away, others can play a waiting game. These differences have become so persistent that reports have arisen that the future of OPEC itself may be in doubt.

Times and fortunes change quickly in the energy arena. But for now, we seem to have exchanged scarcity for a glut. This will change fortunes for both buyers and sellers.

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