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e author is grateful
to Bruegel colleagues,

e continued dysfunction of the World Trade Organisation (WTO) as a negotiating forum, the disabling of its dispute settlement mechanism, the trade war between China and the United States, and a proliferation of protectionist measures (Global Trade Alert, 2021) raise big questions: is the post-war multilateral world trading system, which enabled open and predictable trade, and which coincided with unprecedented economic progress, coming to an end? If so, what will take its place? ese questions are especially critical for the European Union, whose members are among the countries most dependent on trade, and which is multilateralist by virtue of its construction.

e future is unknown, but bad and good scenarios can be sketched out and their consequences examined. Bad scenarios require preparation and mitigation; good scenarios may goods and services. Investment protection is provided by bilateral investment treaties (BITs), while investment market access is governed by national laws and in some instances under regional trade agreements. The WTO's coverage of foreign direct investment in goods remains minimal. However, regardless of their legal separation, trade in goods and services and foreign direct investment have become inextricably connected through the globalisation of production, or global value chains. The locally procured sales of foreign subsidiaries are often larger than exports from a home base, and the lion's share of services trade occurs under Mode 3 (foreign establishment/commercial presence). Therefore, any realistic assessment of the state of the world trading system must include restrictions on investment.

2 The system post-Trump

President Trump was elected on a nationalist and protectionist platform. On his third day in office, 23 January 2016, he abandoned the Trans-Pacific Partnership, a trade agreement that 12 nations, with the US leading, had negotiated over 10 years, but which had not been submitted for ratification by the US Congress. Trump made numerous anti-trade and anti-WTO interventions subsequently, including tariffs on aluminium and steel on national security grounds applied to allies Canada, Japan and the EU, and, most notably, Section 301 punitive tariffs against China, starting in July 2018. Trump also refused to renew the appointment of WTO Appellate Body judges, disabling it at the end of 2019. Though Joe Biden ran successfully against Trump on a platform highly critical of his trade policies, and has mended fences with the EU, he has shown little inclination to date to take a substantially different tack from Trump on China or on WTO dispute settlement. As anticipated during his election campaign, Biden has declined even to consider new free trade agreements as he focuses on the pandemic and economic recovery.

The World Trade Organisation

US dissatisfaction with the WTO long preceded Trump's arrival. The failure of the Doha Agenda – initiated in 2001 – and the failure even to agree that it has died, means the WTO has not been able to move forward on a multilateral deal entailing major trade liberalisation. The Trade Facilitation Agreement of 2013, which marked progress in establishing rules for custom procedures, is the only major achievement since the WTO was established in 1995. The last ministerial conference, held in Buenos Aires in 2017, ended without agreement. COVID-19 has repeatedly forced indefinite postponement of the 2019 conference. During Trump's tenure, the WTO was fundamentally damaged in two ways: the Dispute Settlement Understanding, considered the institution's crowning achievement, has been disabled, meaning that rules are in practice no longer enforceable; and the outbreak of a trade war between the largest trading nations, China and the US, and the associated rule breaking, has undermined the WTO's legitimacy and its prospects for reform.

The WTO contends with divisions among its members on crucial issues beyond China-US trade relations. These include a refusal of members such as India and South Africa to consider plurilateral deals as an alternative to the inoperable single undertaking/consensus procedure; opposition of China and India to the doing away of special and differential treatment for the best-performing developing economies; and the US refusal even to propose reforms of the Appellate Body that would assuage its concerns.

Despite the WTO's dysfunction and the deep divisions over how to reform it, none of its members appear ready to leave or dismantle it. The EU remains strongly committed to multilateral negotiations and has been part of an effort, with China and about 40 other members, to establish an interim arrangement to settle disputes, using arbitration under Article 25 of the General Agreement on Tariffs and Trade (GATT) while the WTO Appellate Body remains inoperable. The Biden administration has departed from Trump by voicing support for the WTO. China has signalled in different forums that it will entertain structural reforms designed to allay concerns about its subsidies and other distortive measures (Dadush and Sapir, 2021). China has joined negotiations on various 'open' plurilateral deals[1], and has helped bring one – on domestic services regulation – to a successful conclusion. The WTO's rule book, its *acquis*, continues to be valued by its members, giving it life despite the shortcomings.

Regional trade agreements

Since 2017, there has been a major acceleration in bilateral and regional deals, and, more importantly, an improvement in their coverage and depth. RTAs notified at the WTO since 2017, or on which negotiations have concluded and are in the process of being ratified, include the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), accounting for over 13 percent of world GDP, and the Regional Comprehensive Economic Partnership Agreement (RCEP), which includes China and several Asian economies that are also part of CPTPP, and which accounts for 30 percent of world GDP. Other notable deals include the United States, Mexico and Canada agreement (USMCA) which revises and extends the previous arrangement, and which also accounts for about 30 percent of world GDP, and the African Continental Free Trade Area (AfCFTA), which accounts for about 3 percent of world GDP. At least two important bilateral deals have come into force: EU-Canada and EU-Japan. Negotiations between the EU and Mercosur have been concluded but the deal faces major ratification obstacles, as does the innovative Comprehensive Agreement on Investment between the EU and China.

The number of RTAs in force notified at the WTO increased by a similar amount in the last five years as it did from 2011 to 2016: 68 in the latter period, compared to 61 in the previous one. Recently, several new agreements arose from Brexit and the subsequent rearrangement

WTO rules – as the counterfactual, which is precisely the assumption that ought to be questioned in the present circumstances.

For the United States, prior to USMCA, the last noti ed agreements were small and date back to 2012, when those with Panama, Colombia and Korea came into force. India has also stood back from major deals, dropping out of RCEP at the last moment, even as it resists all initiatives for WTO reform.

It is di cult to escape the conclusion that, faced with WTO negotiating dysfunction, India's obstructionism and US opposition to the point of withdrawal from its adjudication function, nations worldwide have sought predictability in their trade relations elsewhere. ey are doing so by striking deals with their most important trading partners, even the most distant. If anything, this trend appears to have been reinforced recently, as shown, for example, by China's and the United Kingdom's applications to join the CPTPP[2].

Domestic laws and regulations

and predictable. While trade within the European Union, and that within USMCA, CPTPP and RCEP, to take four major examples, can rely on agreed enforcement mechanisms, trade that is covered only by the WTO cannot. This is an especially ominous development because the world's largest trading nations are by far the most reliant on WTO dispute settlement. No bilateral agreements exist between China, the EU, the US and India, for example. The smallest and poorest nations, in contrast, only rarely resort to the WTO to settle disputes[5], though even the possibility that they can do so is a check on all members.

What is the net effect on trade flows of the restrictive and liberalising interventions that have been put in place over the last five years? This question could in theory be addressed in two ways: by estimating the tariff-equivalent effect of thousands of specific measures, or by examining the recent evolution of world trade against a counterfactual. Unfortunately, without a major modelling exercise (and possibly not even then), neither approach can provide an

Estimates of US welfare losses from the trade war place them at around $50 billion, equal to just 0.04 percent of US GDP (Fajgelbaum and Khandelwal, 2021). And these losses are unlikely to have been o set by USMCA, which – though it contains innovative features – was essentially a revision of an existing agreement. As concerns openness to trade, the US is almost certainly in a worse place than it was ve years ago.

In contrast, trade conducted by the EU is almost certainly somewhat freer than .

Figure 1: annual growth of world GDP and trade volume of goods and services, % change

Source: Bruegel based on IMF *World Economic Outlook* Database, October 2021.

In any event, it is early days to gauge the effects of protectionist measures on global trade flows. Though the atmospherics of trade had deteriorated already in the run-up to Trump's election, and markedly on the US withdrawal from TPP and with the levying of tariffs on aluminium and steel, major restrictive measures took effect only in 2018 with the Section 301 actions against China. The WTO dispute settlement mechanism was known to be under threat even before Trump's election, but it was disabled only at the end of 2019. Growth of trade in 2021 is still only an early estimate.

In 2021, world FDI had recovered from very low levels during the pandemic[7]. However, it remains about 20 percent below the level reached in 2016, on account of a decline in both inward and outward FDI in Europe and the United States, while flows of developing countries, including inward flows to China, have remained at similar levels as five years earlier. Despite the trade war, the US and China retain their ranks as the premier FDI destinations.

Figure 2: FDI inward flows for the world, developed and developing countries, $ billions

Source: Bruegel based on UNCTAD *World Investment Report* 2021.

In summary, some of the institutional underpinnings of world trade have been damaged, while others – mainly due to RTAs – have been strengthened in the last ve years. Because of RTAs, the trade of the EU and Japan is probably freer. US trade is almost certainly less free and trade among the largest economies has become less predictable as the crisis in the WTO has deepened. However, it is not possible to say with certainty whether the net e ect of these big changes is to make trade across the world less or more restricted. ough the headline average growth rate of world trade has not changed, it is also not possible to say whether, because of institutional changes, trade ows have slowed or accelerated relative to a counterfactual where institutional arrangements did not change. If anything, the evidence underscores the resilience of trade and foreign investment, even in very di cult circumstances.

4 Scenarios

Very bad and very good scenarios for world trade are both possible. However, the worst and best outcomes are equally unlikely. A more likely scenario lies in between (Figure 3).

Figure 3: Worst, medium and best-case scenarios for global trade relations

Source: Bruegel. Note: DSU = Dispute Settlement Understanding.

A worst-case scenario is conceivable, in which China and the US decouple, the WTO unravels, and the world descends into a dark age of protectionism, with declining world trade. ere are two reasons to think it will not materialise: globalisation is not stopping, and countries are increasingly compelled to cooperate.

Countries that stand back from globalisation pay a heavy price in terms of foregone welfare and, ultimately, history shows, loss of international competitiveness and political legitimacy [illegible] Td4 (un)]T9 (vy ar)tdl]TJ0 -1v.9 (e slism)4.1 (pndu)15

A best-case scenario, in which China and the US resolve their differences, WTO dispute settlement is reanimated, the WTO recovers its capacity to strike major deals, and MFN tariffs decline, is not impossible, but is also unlikely. There is little reason to believe that the impasse on the big dividing issues at the WTO can be overcome, given the increased complexity of the issues confronting it, the diversity of its membership and the limitations imposed by its consensus rule. The deepening geopolitical and security divide between China and the US adds greatly to the complexity (Dadush, 2022). Trade relations between the two giants are now less dependent on the technicalities of trade distortions than on geopolitics, and the prospects

6 Policy

To deal with a world trading system based on regional blocs, and to guard against worst-case scenarios, countries should initiate or consolidate bilateral and regional deals with their main trading partners, including those outside their geographic regions. Where bilateral deals are not possible, countries should at least seek to establish regular consultation mechanisms. ese could prove useful not only to forge deals when the time is right, but also to avert disputes and, when a dispute occurs, to set up ad-hoc resolution procedures, such as arbitration.

Countries should continue to support multilateral and plurilateral initiatives in the WTO and should aim to re-establish the dispute settlement system in some form (eg arbitration under GATT Article 25 as per the interim arrangement of which the EU is part). However, they should also recognise the limitations of what can be achieved in that forum. Where progress stalls, countries should consider pursuing 'closed' or 'open' plurilateral deals outside the WTO.

Within this broad framework, policy priorities will vary depending on each country's situation: a fertile area for further research.

EU members are already well positioned, since a large share of their trade occurs within the bloc and, as members of a customs union, they can rely on a vast network of agreements with third parties. Some of these are high quality, deep agreements that go beyond trade in goods to cover services and investment. e EU's main challenge is to develop a coherent trade strategy that captures opportunities in China while retaining strong links with the US. e EU's trade policy – like that of China and the US – will be heavily conditioned by geopolitics, so the deftness of the EU's diplomacy will matter greatly in determining trade outcomes. e EU should revive the idea of a trade agreement with the US, perhaps a less ambitious deal than the ill-fated Transatlantic Trade and Investment Partnership. e EU could also consider applying to CPTPP, as China and the UK have done, mainly in a quest to cement its links with all of East Asia, the world's largest and fastest growing economy. e EU and China should seek a political compromise that enables rati cation of the CAI.

China has continued to support the WTO and has complied with its rulings when found materialise. The resuscitation of WTO dispute settlement is largely in the hands of the US, for example.

If – as appears more likely – the US opts for a power-based world trading system, it will retain more freedom of manoeuvre and will derive some advantages in the short-term, but it will also generate great uncertainty for its firms, antagonise its allies and may not retain its dominance for long as China rises. Whichever path it chooses, the US must both expand its network of regional and bilateral trade agreements and seek a basis of understanding with China. Its current stance, which is to impede the WTO dispute settlement mechanism, cast China as the arch-rival and eschew all new trade agreements, is the worst of all possible courses.

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