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The Rules of Trade in the Face of Long Running Disequilibrium

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Abstract

Until a few years before China's accession to the WTO in 2001, it had followed a strategy of self-reliance in its attempt to develop. In international trade this meant near-autarky. In effect, 20 percent of the world's population was not integrated into the global economy. With the end of the Maoist era, this strategy was abandoned, and China decided to integrate into the global economy. Its accession to the WTO facilitated this integration and shocked the global economy into a major disequilibrium and has reverberated and continues to reverberate 20 years later. The result has been a major re-alignment of the world trading system. The re-alignment has created both winners and losers. Those left behind ask for protection to slow the pace of re-alignment. The rules of trade established in the WTO were not designed to deal with such a transformative disequilibrium. Thus, the WTO is seeing countries ignore its rules as they deal with the ongoing challenges brought by the ongoing disequilibrium and its efficacy is diminished.

Keywords: accession, China, disequilibrium, rules of trade, transformative, WTO

Introduction

A common reaction to such simulation experiences is to reject the models as unrealistic, to keep tampering with them until they behave in a more stable manner. I now believe this kind of reaction is based on an unwarranted presumption that real economies are approximately stable, a view which is based on the observation that economic variables often exhibit proximate stability for extended periods of time. Such “finite span viability” is not ultimately reassuring to those who find themselves close to the end of the span.

Richard Day, 1983, p. 22

On what basis should our policy rest? It should rest on our own strength, and that means regeneration through one's own efforts. We are not alone; all the countries and people in the world opposed to imperialism are our friends. Nevertheless, we stress regeneration through our own efforts. Relying on the forces we ourselves organize ...

Mao Tse Tung, 1945, p. 20

The present world is open. One important reason for China's backwardness after the industrial revolution in Western countries was its closed-door policy. After the founding of the People's Republic we were blockaded by others, so the country remained virtually closed, which created difficulties for us. The experience of the past thirty or so years has demonstrated that a closed-door policy would hinder construction and inhibit development.

Deng Xiaoping, 1984

The multilateral trade system is itself a global public good (GPG). It was created at a time when the problems of individual actions by countries to abuse the trade system to maintain employment at home (the disruptive tariffs of the 1930s) were still fresh in the minds of diplomats and technocrats. The GATT sought to avoid such disruptive practices by constraining governments in their choice of trade policy instruments, strongly favoring tariffs, and binding the level of those tariffs to avoid uncompensated increases. The post-war period was an active time for the development of multilateral institutions in both the economic and political sphere. The benefits were seen to be self-evident ...

Tim Josling, 2014, p.3

In economics, disequilibrium is often associated with the work of Joseph Schumpeter, and in particular, *The Theory of Economic Development* first published in 1911 (Day, 1983).¹ In Schumpeter's theory the source of disequilibrium is entrepreneurs, who through their ingenuity devise new or improved products or processes that disrupt markets that are in equilibrium, or near equilibrium. The success of the entrepreneur's innovation sets off a chain reaction in not only the market(s) affected directly but also markets of resources and markets for substitutes and complements. The disequilibrium created by an entrepreneur-initiated *shock* is often expected, after a time, to return to an equilibrium that is close to that which existed before the shock – although it may never actually reach that equilibrium before being disrupted by another shock.

In the case of small shocks, such as the removal of a single tariff, the return to equilibrium is often *assumed* by economists and the cross-market effects small enough to safely ignore in any economic analysis of the effects of the shock – a comparative statics, partial equilibrium model which is the workhorse for much of what economists do, including international trade policy (Kerr, 2007). As a result, much of the economics profession has only limited familiarity with economic dynamics.

Comparative statics is not concerned with the path of adjustment only with the where the new equilibrium lies relative to the pre-shock equilibrium. Economic dynamics is concerned with paths of adjustment. While some paths of adjustment in the wake of a shock lead to new stable equilibriums, others may, however, cycle or follow degenerate paths (Wilman et al., 1987; Cardwell and Kerr, 2009). If shocks follow in quick succession markets will be knocked onto new adjustment paths that do little adjustment before being moved to yet another path. Large shocks lead to an increased probability of adjustment paths whose endpoint lies far from the pre-shock equilibrium and take a long time to adjust to their eventual equilibrium.

The Shock to the International Trade System

Major economic shocks that lead to paths of adjustment that do not return to, or near to, the pre-shock equilibrium have been manifest largely in what are termed transformative technologies (Phillips, 2007). The harnessing of the internal combustion engine as the power source for wheeled vehicles is one example. Starting in the early 1900s, motor cars began to transform not only transportation but societies globally. It opened up possibilities widely and also for the demise of long-standing industries and livelihoods. The examples are almost endless – multi-storied parking garages, oil drilling platforms in the North Sea, asphalt, car hops, autobahns, drive through banks, tanks, drive in churches, remote starters, Formula 1 racing, car washes, Blitzkrieg, body shops,

Firestone rubber plantations in Liberia, detailing, tow trucks, rumble seats, unleaded gasoline, seat belts, car seats for infants – and on and on. The uptake of the automobile also led to the reduced importance of many once prominent professions – farriers, blacksmiths, harness makers, teamsters, wheelwrights, etc. Industries also all but disappeared – livery stables, buggy makers, carriage upholstery, saddleries and a host of others. There was also a major shift in resource use. As gasoline and diesel engines replaced animals as the source of motive power, petroleum became the dominant resource used in transportation, meaning the land that had previously been used to grow animal feed was freed up to produce food for humans. This led to decades of cheap food. Olmstead and Rhode (2001, p. 665) estimate for the US:

The cropland used to feed horses and mules peaked in 1915 at about 93 million acres; 79 million acres for maintaining work animals on farms and 14 million acres for those off farms. From 1915 on there was a steady decline. In 1930, 65 million acres of cropland were used to feed horses and mules, with all but 2 million acres devoted to farm stock. By 1960 only 5 million acres were needed. The released land was roughly equal to two-thirds of the total cropland harvested in 1920 in the territory of the Louisiana Purchase.

The arrival of the automobile was not a one-time shock. It set off a series of interrelated shocks that have reverberated for over 100 years and never allowed the affected sectors to reach a new equilibrium. Although gasoline and diesel engines may have run their course, the shift to electric engine motive power is setting off another wave of disequilibrium across many sectors. Such is the nature of transformative technologies.

The harnessing of steam power for use in rail and maritime transport as well as stationary engines is an earlier example. Electrification is another. Currently, the potential of biotechnology, genomics and gene editing is often cited as a likely transformative technology (Kerr, 2014; Smyth et al., 2015). Political events can also kick-off a major disequilibrium. One example is the request from local leaders in Britain that Rome withdraw its officials – setting off a downward spiral that culminated in the dark ages a few hundred years later (Kerr, 2016). In international trade, when intrepid Portuguese traders were able to finally open links with the sources of spices in Asia by rounding the horn of Africa, the comfortable monopoly in spice trade through the Mediterranean long enjoyed by Venice was effectively outflanked with dire consequences for the region's prosperity (O'Rourke and Williamson, 2005; Van der Wee, 1990).

The need to integrate China into the global economy, starting in the early 1980s, represents a shock that put the global economy into a reverberating disequilibrium that

has not yet run its course by the start of the 2020s. While China began taking tentative steps toward integrating into the global economy in the early 1980s, 2001, when China joined the WTO, is often taken as the starting point for it joining the global economy. Prior to that, as a non-member, China's international trade was at the mercy of importer's trade policy initiatives. For example, in the years prior to accession, China's market access was reviewed annually by the US (Rhodes and Jackson, 1999). Accession meant that China's trade would be conducted under the rules of the WTO agreements and not subject to, from the Chinese perspective, capricious trade actions, or threats of capricious trade actions. The surety provided by the WTO umbrella reduced the risk associated with investing in trade activities in China, whether domestic or foreign. Hence, after accession in 2001, China's integration into the global economy quickly gathered momentum. In 2000 the Chinese population was 1.242 billion out of a global total of 6 billion. Thus, just over 20 percent of the world's workforce had been excluded from participating in global trade.

In the wake of the Chinese civil war in the late 1940s and the fallout from participation in the Korean war, Mao Tse Tung and the Chinese leadership turned inward vowing to go it alone in its drive to develop – *self-reliance* (Ceko and Kerr, 2000). The self-reliance development strategy of the Chinese Communist Party (CCP) was partially the result of other countries failure to recognize the legitimacy of the Communist state. Although Chiang Kai-shek and his Kuomintang government had retreated to Taiwan after its defeat in the civil war, it claimed this was only a temporary setback and that it was still the legitimate government of all China (Matsumoto, 2018). More important, the Republic of China (ROC) under Chiang Kai-shek continued to be officially recognized as the legitimate government of China at the UN and other international organizations.² The Peoples Republic of China (PRC) was diplomatically isolated. As a result of the participation of the PRC in the Korean War as well as general Cold War tensions, the US and its allies attempted to isolate Mao's China as part of their effort to halt the spread of Communism in Asia. This isolation increased when China broke with the Soviet Union in the late 1950s. Prior to that the PRC had received considerable technical assistance from the Soviet Union. Thus, the PRC was forced to *go it alone*.

Being free of foreign entanglements and influences also had its benefits as it allowed Mao to consolidate the control of the Communist Party in the country and to conduct its strive to become developed without direct oversight (Cain and Kerr, 1987). Under Mao, China's development strategy was ideologically driven and its policies devised from within. By being closed to the outside world, foreign influences were minimized relative to the case of more open economies. Open trade is often seen as a

means to foster institutional change so keeping China isolated allowed the institutions constructed by the Communist Party to bolster its continued control (Kerr and MacKay, 1997). The result was that China traded minimally and its economy was not integrated into the remainder of the global economy.

The idiosyncratic and sometimes chaotic development strategies of the Mao era did not produce the desired result. There was at times widespread famine and terrible wastage despite urgent striving and sacrifice. Self-reliance did not produce the desired result. With Mao's death, and under the leadership of Deng Xiaoping, self-reliance was put aside. Trade was to be a major pillar in China's modernization. The integration of the 20 percent of the world's population that had been isolated for 50 years began in earnest with the PRC's accession to the WTO in 2001.

China represented a vast, untapped labour force that became available to domestic and international entrepreneurs. With market access relatively secure due to WTO agreements, entrepreneurs and investment flowed into China to produce low-cost exports. China quickly went from the seventh largest exporter of manufactures to the largest. According to Islam (2021):

China's accession to the top table of world trade heralded a massive global transformation. A powerful combination of China's willing workforce, its super-high-tech factories, and the special relationship between the Chinese government and Western multinational corporations changed the face of the planet.

An army of cheap Chinese labour began to produce the goods that underpin Western living standards, as China seamlessly inserted itself into the supply chains of the world's biggest companies. Economists call it a "supply shock", and its impact certainly was shocking. Its effects are still reverberating around the world.

Accession was the start of a transformative event. The initial disequilibrium created by the application of WTO rules to China's international trade and the following surge in exports and inbound foreign investment began altering existing economic arrangements around the world. Chinese firms utilized their low-cost labour advantage to offset their higher transaction costs until learning by doing began to reduce those costs – leading to more export success, and more disequilibrium over time. Some western firms could not compete and, over time, had to leave their industry – with commensurate job losses. Others began themselves to directly avail themselves of Chinese low cost labour through offshoring jobs. Expanding output in China created demand for technology and resources in China causing both an expansion and redirection of trade. In the case of Germany, for example, it meant an increase in the export of specialized machinery. Resource rich economies such as Australia and Brazil

experienced expansions in their mineral and agriculture sectors. As the economy grew, China began to have the resources to expand and upgrade its transportation infrastructure meaning that an ever-increasing proportion of the economy was connected to the global economy. As a result, Chinese goods penetrated deeper and deeper into international markets. China became the world's largest trading economy meaning a wholesale re-alignment of world shipping routes. To find workers to populate the urban factories, a large-scale internal migration from rural areas took place in China. As it became increasingly integrated into the global economy new and better skills were acquired meaning products with higher levels of technology could be exported meaning higher skilled employees in importing markets were made redundant. Wages in China began to rise so that some low skilled activities were moved to lower cost countries such as Vietnam and Bangladesh. The world economy realigned in response to the shocks of knock-on disequilibria.

While the net result of integrating the Chinese economy into the global economy has been positive for the world's economy, such changes create winners and losers. The effects of the integration of the Chinese economy into the global economy were not distributed equally. The losers sought protection from their politicians (Kerr, 2016). There was increasing talk of *those left behind* as a result of the realignments that represented the paths of adjustment arising from disequilibria. The most high-profile political manifestation of anti-China protectionism was the election of Donald Trump as US president. Of course, there were many factors that contributed to the election of President Trump, but his promise to deal with China was one of them. His administration's strategy for dealing with China has been analyzed at length elsewhere (Kerr, 2018). Thus far, his successor, President Biden, has left much of the Trump administration's protectionist policies in place. The disequilibrium continues.

Despite their bad experience with trade agreements concluded with Western powers in the 19th and early 20th centuries (Kerr, 2019), China sees the value in the current WTO arrangements. Since accession it has largely abided by the WTO rules although like most countries interprets its commitments as loosely as it can safely getaway with and uses its power and economic size to full effect. It is the subject of numerous disputes, but tends to comply with adverse rulings, however grudgingly. Instead, it has devised a proactive trade strategy that is based on activities not covered or not adequately covered by the WTO such as technology transfers built into joint venture agreements,³ subsidies to state owned enterprises and industrial espionage, among others (Kerr, 2020). There is nothing in WTO law that allows trade policy measures to be used to counteract these practices. The Trump administration, for example, tried to use tariffs to induce a change to these Chinese business practices – only to have disputes brought asserting that their

imposition violated WTO rules. This has caused, for example, Americans of both political stripes, to question whether the existing rules of trade are *fit for purpose*.

The Rules of Trade

The existing set of rules for trade, as embodied in the WTO agreements, were devised, it can be argued, at a time of near equilibrium. It was a low equilibrium for economic activity and, in particular, international trade. Normal trading relationship had been put on hold during the second world war and the post-war return to economic normalcy stymied, in part, by the high tariffs erected in the chaos of the Great Depression. Those tariffs were put in place or raised in desperate, and misguided, attempts to help save domestic jobs during the depression. In the late 1940s they were inhibiting economic activity and the benefits the gains from trade could bring. Only a few countries negotiated the original GATT-1947 and less than 30 signed it. It had only very limited ambition – the reduction of those high tariffs. A much larger number of countries participated in the negotiation of the International Trade Organization in Havana, but its much wider trade policy remit was too radical for the US Congress and it was stillborn (Kerr, 2000). Those negotiating the GATT did not envision a radical reduction in tariffs. Rather, they envisioned a forum where the principle of reciprocity was central and contracting parties would successively negotiate reductions in tariffs – in *Rounds*. It was to be a mechanism to encourage small changes that could be achieved, adjustments made, and then the next set of changes negotiated in a new *Round*.

The economic model that underpins the GATT, and subsequently the WTO, is a partial equilibrium and comparative static construct (Kerr, 2010). It envisions no paths of adjustment, just a move to the next equilibrium. Classic comparative statics. As tariffs are applied to individual products in the tariff schedules filed by WTO members, the small changes in tariffs negotiated would not be expected to impact other markets in significant ways and, thus, could be safely ignored – i.e. partial equilibrium is appropriate. Further, the *decisions by consensus* structure re-enforces idea of small changes as it would be unlikely that changes with large impacts could ever be agreed by consensus.

The requirement for consensus instead of some voting rule, or weighted voting rule, was needed to encourage countries to join the agreements and to remain in the organization. Other major shocks to the GATT/WTO such as the rapid expansion in membership as countries shed their colonial status and became independent were muted as the new members were not particularly interested in liberalizing trade with many actively pursuing development strategies based on import substitution (Gerber, 2007). As a result, those countries interested in trade liberalization were able to continue in

their roles as makers of trade policy without much interference until the run up to the initiation of the Doha Round (Kerr, 2002). It was the era of *Green Room* negotiations at the GATT whereby only subsets of interested parties took an active part in the negotiations. In the case of China, it joined the WTO because it was interested in using trade as a springboard for its development and modernization.

The accession of China did not result in a small shock to the international trade system but rather a massive re-alignment of international trade that led to many *losers* seeking protection. The integration of China into the global economy would have taken place even if China had not acceded to the WTO but countries wishing to put protectionist policies in place to slow the re-alignment of international trade would have been free to do so. They would not have been fettered by WTO rules. It should not be surprising that countries that have large concentrations of *losers* have been increasingly willing to ignore WTO rules, and the organization.

The problem is not particularly with the WTO's rules of trade or its inability to re-negotiate due to the need for consensus. There have been a large number of preferential trade agreements negotiated since China's accession to the WTO – some of which have included China. They have shown little inventiveness in terms of devising rules that differ significantly from those of the WTO. In the Trans-Pacific Partnership negotiated with US participation there were *better than WTO* provisions on the protection of intellectual property but little else. In the direct US negotiations with China during the Trump administration the major achievement from the US perspective was a provision whereby China agreed to purchase specified quantities of some US goods – hardly an inventive solution to the US trade difficulties with China. The problem is the size and continuing evolution of the disequilibrium caused by China's joining the world trading system and the global economy. The WTO rules will only be a constraint on the use of trade policy if, or when, the disequilibrium dissipates.

Conclusions

China deciding to alter its development strategy from autarkic self-reliance to trade led growth set in motion a major re-alignment of global trade. It meant that the productive capacity of approximately 20 percent of the global work force had to be integrated into the international economy when, previously it had hardly participated at all. A major disequilibrium in markets was put in motion where no quick return to the previous equilibrium – or for that matter any equilibrium – could be expected. Thus far there has been more than two decades of adjustment and no sign that the reverberations have ceased. In the process of change many *winners*, but also many *losers*, have been created. They *losers* are being left behind in the global re-alignment of trade and global

economic activity. They ask for protection from their politicians – and sometimes the politicians wish to respond to those requests. They want to use trade policy to slow down the need to adjust and reduce the costs of adjustment for some of their constituents.

The rules of trade agreed at the WTO were not designed to deal with the transformative nature of China's integration into global trade and the world economy. The WTO and the economic model underpinning it were designed with only small shocks and quick returns to equilibrium in mind. One cannot expect countries to abide by rules that are not *fit for purpose*. Until the end point of the disequilibrium becomes clear, and whether there is to be a role for the WTO, the efficacy of the existing rules of trade will likely be diminished.

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Endnotes

¹ The edition of *The Theory of Economic Development* published in 2017 provides an accessible version.

² The Republic of China formally withdrew from the General Agreement on Tariffs and Trade (GATT) in 1950 as it felt it could no longer live up to its obligations.

³ Western firms complain about this Chinese practice, but they are under no compulsion to enter into such agreements – they can choose not to enter the Chinese market.