Economic Diplomacy in the 21st Century:

Principles and Challenges

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Economic diplomacy in this century will face a different set of challenges stemming from the changed global economy, US-China tensions, as well as a backlash against globalisation, among others. The turn of the century saw the emergence of a multi-polar world economy, in which the United States was no longer the main engine of economic growth. The shift in economic weight was due largely to the growth of China and other Asian emerging economies. The European Union remains the world's biggest economic bloc, but Asia in particular has started to add hundreds of millions of people to the world's new middle class. Still, the two engines of global economic growth are the US and China. Their tensions have evoked terms such as a return of Great Power competition.

So, the conduct of economic diplomacy, i.e., how a country manages its foreign economic relations including trade and investment, must adapt.

Principles and Challenges

The framework for economic diplomacy should seek to balance commercial openness with strategic foreign policy aims, broadly defined. It should situate a country within the 21st century global economy with its new drivers, promote a rules-based system in order to mitigate Great Power tensions, and recognise that all foreign economic policy is ultimately also domestic.

There is no one general approach but there are several principles, each with their own challenges, for governments to consider.

First, the setting of trade and investment policy should position a country optimally in a global economy in which trade in services and data are growing in prominence. The growth in trade in services and the digitalisation of trade are part of the "invisible balance," a term that refers to the cross-border trade of intangibles, which ranges from business services to e-books, and more. Under the World Trade Organization (WTO), tariffs on manufactured goods have dropped significantly and are fairly low for most goods, though there is still scope to reduce them and open up markets. The focus increasingly is on non-tariff measures, which may take the form of digital services taxes, and other regulations and licenses. While many of these can prove to be necessary and helpful as matters of tax and privacy policy, they may also function as impediments to trade of all kind if not properly coordinated. Indeed, the WTO has been advocating greater liberalisation of services trade in part to increase trade in goods.

For services-based economies in particular, free trade agreements (FTAs) will need to encompass regulations and standards, which is challenging when the US and China as well as the EU and others have different legal and regulatory systems. It raises the prospect of a fragmented global trading system. The world could potentially divide into blocs where different groupings of countries adhere to different technological and other standards. The remedy would be to pursue a multi-lateral approach such as the stalled Trade in Services Agreement (TiSA), which was launched in 2013 by advanced economies to set global standards that further open up services trade. Their hope was to gain enough support so that it could become a new multilateral round of trade liberalisation under the WTO. But progress on the initiative has come to a halt with the change in US administration. China, moreover, never joined the TiSA negotiations. It is difficult to achieve meaningful, global trade liberalisation if neither economic superpower is at the table—not least for different reasons—but the US and China's escalating economic confrontation has put progress out of reach even when the superpowers are present. This leads to the need to consider the global opportunities and responsibilities of other advanced economies, which is discussed later in this Strategic Update.

Second, in an era of heightened tensions, the framework for economic diplomacy will need to be transparent. A principles-based framework could be one that is centred on commercial openness which is consistent with foreign, security and other relevant policy aims. Spelling out the ways in which foreign investment will be reviewed, for instance, to ensure that it does not contravene other objectives, would reduce uncertainty and not single out a government. That would reduce a tendency to use trade measures to resolve political or other commercial tensions. It is particularly important where there is a lack of trust not only between the US and China, but also between other countries such as Japan and Korea, where trade disputes are not separate from political and even historical disputes.

The challenge will be to specify a framework that can reconcile at times competing policy aims while furthering an overall objective to situate the country optimally in the 21st century global economy. The questions include whether trade agreements should encompass non-economic elements, such as national security. Do concerns over national security mean that trade and investment agreements should be fashioned to favour countries that are allies? In other words, could such a framework assess a trading or investment partner not only in terms of the growth of their market but also their position on defence or based on other alliances?

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Third, any foreign economic policy has to be driven by domestic considerations. There should be no distinction between foreign or domestic economic policies in terms of assessing the distributional impact on society. The lesson from the backlash against globalisation, not just in the recent period but also in the centuries prior, is that trade creates losers even while the country as a whole gains. FTAs and investment agreements, and all foreign economic policies, should take into account the wage and employment effects. There could, for instance, be a distributional assessment included in every proposed trade and investment agreement so the impact on the society and localities can be made evident. That would help inform whether such an agreement should proceed. A similar distributional analysis has been part of the UK Budget which sets out domestic economic policies. There would be similar benefits for such an impact assessment to be included in trade and investment agreements.

Importantly, addressing negative distributional effects cannot just be done via trade agreements. A level playing field and incorporating employment and environmental standards are increasingly part of trade agreements. Such measures will help but are not sufficient.

Domestic fiscal policy, notably tax and government spending, are important—not only because these are the embedded mechanisms for redistributive policies but also because it is difficult to untangle the impact of trade from other factors, such as automation. Skill-biased technical change refers to both technology and globalisation influencing shifts in the economy that favours highly skilled workers. The two factors are inter-related, though automation usually has a larger effect. Even though the causes can't be distinguished, the effect is to squeeze the middle income and mid-skilled workers. The remedy would still be to help those who have been affected and invest in their skills so that they can better adapt to a changing economy that will be driven by globalisation and especially technological change which will not be possible to predict.

Fourth, domestic aims should underpin trade and investment policy. For advanced economies, the need to raise productivity growth is of paramount importance to ensure that standards of living do not stagnate. Trade can help improve efficiency, which is the basis of comparative advantage and why all countries trade in order to specialise and then exchange with other nations. But comparative advantage can also be shaped, as new trade theory has highlighted. For instance, a country can improve its productivity in higher skilled industries to help shape its comparative advantage. Therefore, to prevent a country from specialising in low value-added sectors requires domestic policies that support innovation and skills, among others.

Foreign economic policies should further those aims, which is enabled by developing a competitive domestic economy that is bolstered by trade and foreign investment. For example, a flourishing Information and Communication Technology (ICT) sector can attract investment from abroad while also supporting exports. In this way, to boost inward investment as well as trade requires domestic policies that support the ICT sector, such as digital infrastructure, innovation and skill development. With a supportive ecosystem, the sector can become a source of competitive strength that will be enhanced by greater international trade and investment. Without such a source of competitiveness, there are limits to what foreign economic policies can achieve as a government cannot sell abroad what it does not possess in abundance.

Fifth, the appeal of a country as an international hub or a good place to do business has much to do with its governance and institutions as well as its culture and values. In a world in which the multilateral rules-based system is under strain, it is even more important to promote the values that define a society and make it somewhere that people want to visit, invest in, and work and travel to. This can be described as the projection of "soft power," the hard-to-measure influence that a country possesses which can make a difference. Investment can be driven by John Maynard Keynes's "animal spirits," that is, decisions may not necessarily based on conventional measures of risk but on perceptions and beliefs. The economic impact of soft power that can enhance a country's reputation should not be under-estimated.

This is where the diplomacy part of economic diplomacy can come into its own. It's not just negotiating trade or investment agreements, but it's the projection of the values that characterise a society. By crafting an economic system that is rules-based and fair as well as pragmatic, a country espousing the importance of adhering to rules and norms abroad would have greater credibility. This isn't new, but how to integrate and incorporate "soft power" into a country's foreign economic policy is the challenge. Relying more on civil society, such as charities and non-governmental organisations as well as cultural entities, which often operate abroad is one aspect. Including such stakeholders in the formation and operation of a country's foreign economic policy can help reinforce and promote soft power that emanates not just from the centre but from the grassroots. Other stakeholders such as businesses, trade unions, consumer watchdogs, etc. should be included in a similar manner. A number of large multinational companies already deploy their own version of economic diplomacy since they often have experience in working with governments from around the world as do other stakeholders who work across national borders.

Finally, all countries would also need to consider whether it should have a larger global role. In an era in which the Great Powers have different values, including democracy, and where the international system is under strain, should part of a country's economic diplomacy include a global role? The stalling of multilateral trade talks and the importance of coordinated action on global public goods, such as health and the environment, indicate there is a pressing need. Reform of existing institutions and forming new voluntary networks of countries, such as the new UN forum on climate, can exist side-by-side. The global system already has multilateral and regional as well as bilateral arrangements. It is likely to have more given the Great Power tensions.

Incorporating global stakeholder responsibilities is all the more important in a fractured system. One approach would be for major economies, such as the UK, to build alliances of like-minded countries to spur action on specific issues where there is an impasse due to disagreements between the Great Powers. Advocating for a rules-based multilateral system from a relatively neutral position is more likely to be fruitful in such a divided world. The challenge will be in engaging the Great Powers without whom widespread adoption is less likely. But if the genesis of a proposal does not stem from either the US or China, then the chances of it becoming a multilateral rule or standard might be better. But to be an "honest broker" in an era of Great Powers is not straightforward. The rules-based system is not itself neutral since the rules are fashioned by countries with their own objectives. A goal of economic diplomacy is to get as much buy-in as possible.

Conclusion

The diplomacy part of foreign economic policy doesn't get as much recognition as the "harder" aspects such as FTAs or investment treaties. But in an era of Great Powers, "soft power" and economic diplomacy may hold the key to not only an effective set of policies for a country, but also to rejuvenating the global economic system.

In this era, in which the economic superpowers are increasingly at odds and the international economic order requires reform, there is a clear need for new modes of global engagement. Countries will need to craft a set of foreign and economic policies that are consistent and align with the values of their societies. There will inevitably be tensions and competing aims, but a transparent framework would show that decisions and judgements are made based on rules and norms.

Importantly, the distinction between foreign and domestic economic policies should become less relevant. Trade and investment policies need to be consistent and enhance domestic economic policies and vice versa. Domestic buy-in and the distributional impact of foreign economic policies are as important as securing support for new domestic taxes or spending decisions.

The 21st century global economy offers significant opportunities and also challenges for the conduct of economic diplomacy. It is during such times of upheaval that a new consensus around the principles which should govern a country's relations with other countries can be re-shaped, which can in turn help enhance the overall international economic system. ■

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