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POLICY OUTLOOK

Resurgent Protectionism: Risks and Possible Remedies

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Summary

- Although the impact of trade-restricting measures enacted so far is small, the risk of a devastating resurgence of protectionism is real.
- A trade war today would generate even greater losses than those associated with protectionism during the Great Depression.
- International leaders at the G20 meeting on April 2 must devise a coordinated and transparent plan to re-ignite growth and avoid a resurgence of protectionism, including extending the moratorium on new trade restrictions to 2010.
- World Trade Organization surveillance of national recovery measures should be unequivocally endorsed. Recovery measures—though essential—should be temporary and have a clear exit strategy.
- Leaders should reassert a determination to conclude the Doha Round by the end of 2009.

As the global financial crisis intensifies, world leaders are facing growing political pressure to enact protectionist measures. Since the inaugural G20 summit was held in November, nearly all G20 members, including the United States, the EU collective, China, India, and Russia, have taken steps whose effect is to protect their own producers.

While the impact of measures enacted so far is small, the risk of a devastating resurgence of protectionism is real. A resurgence of protectionism today would generate even greater losses than it did in its last surge during the Great Depression, when tariffs were much higher at the outset than they are today and countries were less integrated through complex international production chains.

Counter-cyclical policies and banking bailouts are absolutely necessary to contain the crisis. But they also imply a much expanded role of the state in—and therefore an expanded risk of politicization of—economic decisions. Even when support measures are intended to mitigate the downturn, their unintended effect is often to protect, and such measures can easily be misinterpreted by other governments as protectionist even when they are not intended to be. If, as is unfortunately quite possible, the crisis continues to deepen and becomes even more protracted, the pressures to protect could become overwhelming.

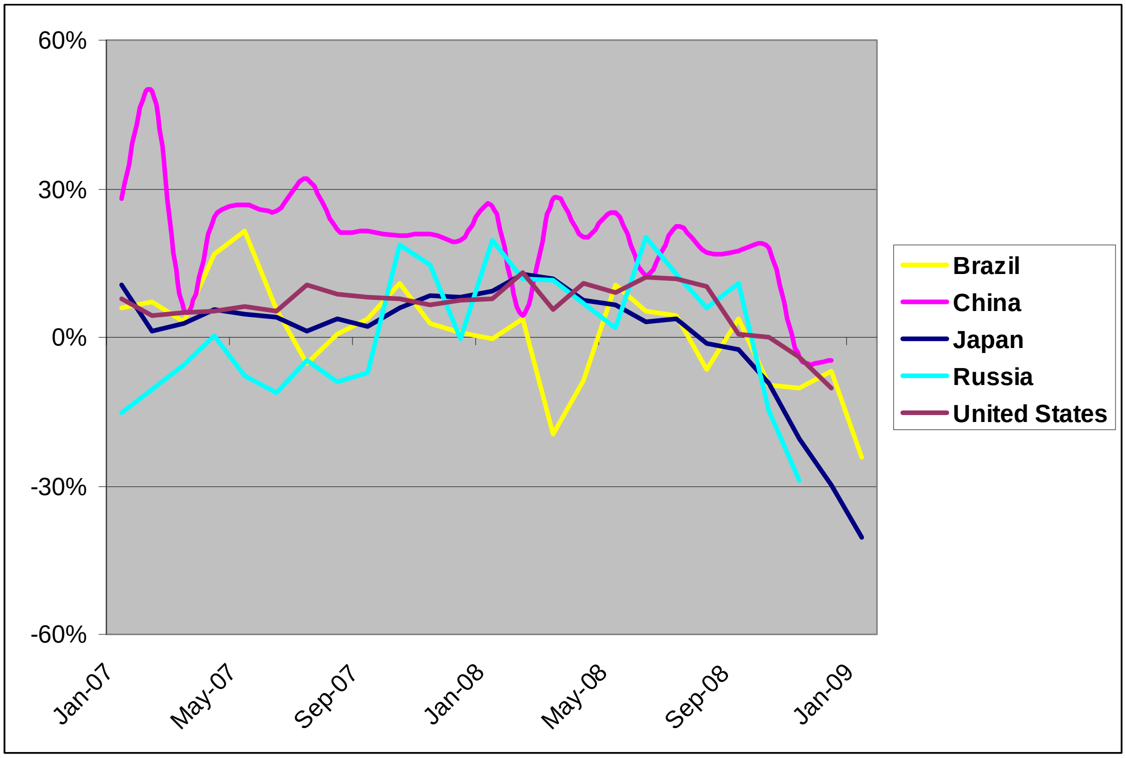
Policy makers at the coming G20 meetings need to take important and urgent steps to avoid backsliding or, worse, a trade war. Establishing a monitoring function with teeth in the WTO is an obvious immediate step. The G20 must also strengthen the world trading architecture so as to avoid backsliding during future downturns. Reforms of the WTO, not only the World Bank and the IMF, should be the object of a dedicated G20 working group in preparation for future meetings.

Rising Risk of Protectionism

1. Intensity of the Crisis

Experience of previous crises suggests that the pressure to protect grows in step with the speed, depth, and duration of the downturn. The impact of the current economic downturn has been momentous, not just in scale, but also in the rapid pace with which it has transformed from an isolated U.S. and Western European financial crisis into a global meltdown pervading all sectors. In the fourth quarter of 2008, world industrial production fell at a 20 percent annual rate; these declines have so far continued unabated in the first quarter of 2009. Jobs are being shed in every country; the ILO expects 50 million workers around the world to become unemployed due to the global recession. The dearth of trade finance, combined with reduced global demand, has had an immediate and significant impact on global trade, which the World Bank predicts will contract in 2009 for the first time since the early 1980s.

Figure 1: Percent Change in Export Volume
y/o/y seasonally adjusted



Source: World Bank Global Economic Monitor.

The effect of the crisis on developing countries is very recent but promises to be severe in the aggregate, and catastrophic for a few. A sharp decline in external finance to developing countries has already occurred and is predicted to get much worse in 2009. Eastern European countries, many of which have large current account deficits that circumscribe space for fiscal and monetary policy, lay most exposed. Some are at direct risk for default unless their neighbors to the West and the international financial institutions (IFIs) provide direct assistance.

Though most forecasts predict recovery sometime in 2010, the unprecedented nature of this episode makes these projections exceptionally uncertain. Furthermore, financial crises tend to last longer than recessions driven by other factors. A typical recession results in less than one year of output growth well below trend; however, in both advanced and developing economies, financial and banking crises are typically associated with three years of GDP growth below trend.[1] Assuming this crisis conforms, the United States would currently be only about one-third to one-half the way through its recession, while in the vast majority of other countries, where the recession is younger, recovery would likely require even more time. Lessons from past financial crises also indicate that today's global downturn may continue to deepen. Decline in GDP peak to trough during financial crises is most typically around 5 percent.[2] The Great Depression saw a decline of 25–30 percent of GDP. To date, the decline in U.S. and European GDP from peak is probably no more than 2 to 3 percent.

Despite the damaging and pervasive effects that this crisis has already had on the world economy, it has been thus far relatively short-lived and shallow in comparison to past crises. However, given the history of such crises, we should not be surprised if the global economy continues to deteriorate, further driving the growing pressure for protectionism.

There are reasons to think policy makers have learned from past crises, and that this episode will be better managed than most, but there are also reasons to think that underlying problems—both those that caused the crisis and those that limit the scope for policy response—run deeper than in past crises. Debt levels as a share of GDP in the United States and the UK have never been higher.[3] New tools such as securitization, credit default swaps, and derivative contracts have made financial intermediation more complex than ever before. Capital mobility—which is associated with increased crisis frequency—is at an all time high.[4] Furthermore, whereas during most crisis episodes countries could rely on world trade demand for support, in this case world trade demand is fading rapidly. These limitations to recovery may also deepen public mistrust of economic integration.

2. Growing Role of the State and Weak WTO Disciplines

The size of today's government intervention is unprecedented; the planned U.S. financial bailout packages alone account for 17 percent of GDP. While the size of the intervention does not by itself create room for protectionism, its *non-neutral* nature does. Support to domestic banks, finance companies of industrial conglomerates, and the auto companies, is clearly discriminatory. Furthermore, two-thirds of the most recent U.S. stimulus package is allocated to infrastructure, science, health care, and other initiatives. Within each of these categories, policy makers, not the market, decide which groups will benefit from an injection of government money and which will not, incentivizing groups to lobby to receive a disproportionate share of the benefits. Groups have been particularly successful in lobbying for funds to be allocated toward national companies to preserve employment opportunities for citizens. For example, the "Buy America" provision of the U.S. stimulus package provides a 25 percent competitive margin for U.S.-manufactured goods for all expenditures under the bill.[5]

Even when stimulus packages require, as does the U.S. bill, that provisions be consistent with the country's obligations under international agreements, policy makers retain flexibility to discriminate without breaking WTO laws. For example, a large share of manufactures imported into the United States originate in countries that are not signatories to a relevant government procurement code, so steel originating in China, Brazil, India, or Russia, will be placed at a 25 percent disadvantage in infrastructure projects.

There are many other opportunities as well. Developing countries tend to have large gaps between bound and applied rates, and, for several goods, have no bound rates at all. Industrialized nations could withdraw their Generalized System of Preferences, which offers the least developed nations lower tariffs than offered to other nations. All nations are also permitted to raise compensating tariffs against a trading partner found guilty of dumping or of implementing distortionary subsidies. Standard setting bodies have wide discretion. Finally, the WTO still has several salient gaps in its jurisdiction; for example, protectionist bailouts and investment restrictions are allowed in many sectors.[6]

3. Protectionist Measures are Increasing

While protectionism so far has probably had only a modest effect on trade flows,[7] it is clear that countries are increasingly resorting to protectionist measures. Whereas the trend over the last two decades has been toward increased liberalization, since the financial crisis worsened in November, the majority of trade measures enacted around the world (55 out of 77) have been trade restrictive.[8] Half of these measures were tariffs, while the other half was comprised of subsidies, licensing requirements (e.g., Argentina), restricted entry (e.g., Indonesia), tighter standards (e.g., China), and outright bans (e.g., India).

Developing and industrialized countries have employed starkly different tactics to protect domestic industries. Industrialized countries are more likely to use subsidies; all twelve trade measures enacted by industrial countries since November involved financial assistance to domestic companies. Developing countries, however, often do not have the budget to enact costly subsidies, nor can they raise funds for such measures through issuing large volumes of debt, as many industrialized nations do. Instead, developing countries tend to rely on tariffs and other non-fiscal protection. Consequently, only a third of the 43 developing country measures since November have involved subsidies.[9]

Of these measures, WTO Director General Pascal Lamy finds that the most influential have been OECD countries' support to banks, other financial institutions, and the automobile industry.[10] Subsidies for the auto industry now total some $48 billion worldwide, $42.7 billion of which is in high-income countries.[11]

Final evidence of protectionism can be seen in the increased number of anti-dumping complaints filed with the WTO, which, after years of decline, rose by about 15 percent in 2008.

Flexible exchange rates may have forestalled an even more widespread resort to protection. Exchange rates against the U.S. dollar and the Chinese yuan have plummeted, 20 to 30 percent on average and even more against the yen, giving import-competing interests outside the United States, China, and

Japan—three of the largest trading countries—considerable natural protection. Further, the floating rate regimes may have preempted a wave of competitive devaluations like the one that disrupted markets in the 1930s.[12] However, there is clearly a limit to the use of this safety valve, as is shown, for example, by the collapse of manufacturing output and the depth of the recession in Japan.

4. POTENTIALLY LARGE LOSSES FROM PROTECTIONISM

The potential losses from trade restriction could be huge. The International Food Policy Research Institute (IFPRI) estimates these losses by examines two scenarios of protectionism. In the more modest scenario, countries raise their tariffs to their maximum rates applied during the period from 1995 to 2008. As a result, world trade decreases by 3.2 percent and world welfare falls by $134 billion. In a more severe scenario in which countries raise tariffs up to their WTO bound rates, world trade decreases by 7.7 percent and world welfare drops by $353 billion.[13]

However, this may be an underestimate of the potential losses from protectionism, as even the severe scenario assumes that countries stay within their WTO legal limits. The current crisis is triggering extreme economic hardships—many of which have not been seen since the GATT/WTO's conception—that may put unprecedented pressure on members to break commitments. Furthermore, the WTO dispute-resolution system has neither the capacity to handle a high load of disputes, nor the power to enforce its laws through any means other than by permitting reciprocal retaliation. Therefore while the current general expectation is that countries will abide by their WTO commitments, this obviously cannot be taken for granted in the event of an all-out trade war.

If countries do choose to raise tariffs levels and other barriers above WTO limits, we may see a severe contraction of trade not seen since enactment of the Smoot Hawley tariffs in the wake of the Great Depression. Following the Smoot Hawley Act, the effective U.S. tariff rate rose from 13.5 percent in 1929 to 19.8 percent by 1933, encouraging retaliation on the part of U.S. trading partners. The combined effect of falling demand and increased protection led to U.S. imports falling from $1.3 billion in 1929 to $390 million in 1932. U.S. exports fell from $2.3 billion to $784 million over the same period. Over the same period, world trade declined by 33 percent, and the increase in both tariff and non-tariff barriers may have accounted for a little over half this decline.[14]

However, even the Smoot Hawley experience may underestimate the potential damages from protectionism today. The impact of raised tariff barriers in the 1930s was likely mitigated by the relative unimportance of trade in the U.S. economy during this period. In 1929, imports accounted for only 4.2 percent of GNP and exports only 5 percent. Today, imports comprise over 14 percent of GDP and exports 11 percent. Average U.S. tariffs today are also a fraction of what they were in 1929; even a small increase would significantly affect trade flows. Trade shares are much higher in other countries, and tariffs are on average less than one fourth of what they were in 1929. Raising tariffs today would likely inflict much greater damage on the global economy.

5. Who Would Lose the Most From Protectionism?

All countries would be adversely affected by restraints on their exports or by measures that affected the overseas operations of their multinational companies. Not surprisingly, smaller countries or territories (such as Hong Kong) are typically the most open and most exposed. But large countries such as China and Russia have high export exposure as well, and both the Eurozone and UK have relatively high outward FDI stock as a percentage of GDP, making them vulnerable to retaliation from other nations closing their borders to investment or discriminating against existing foreign establishments. The United States is among the relatively least exposed, with an outward FDI stock that comprises 19 percent of GDP and exports that amount to only 11 percent of GDP, but its absolute losses would be among the largest.

Bad as the expected export losses would be, welfare losses from countries' own import restrictions would likely be even greater. While specific interest groups can gain handsomely from protection, the main victims of protectionism are the countries that engage in it.

Policy Recommendations: Mitigating Protectionist Risks Now

- The most effective way to defuse protectionist pressures is to reignite economic growth quickly. Acting aggressively on the broader economic recovery agenda, including injecting fiscal and monetary stimulus, removing non-performing assets from bank balance sheets, and helping the most vulnerable countries and groups, is essential. But the way this is done is also important. Stimulus and financial rescue policies should aim to be as non-distortive of competition, both foreign and domestic, as possible. Support measures should be temporary and have a clear exit strategy. Furthermore, insofar as the burden of economic recovery policies is shared across countries, and is *seen* to be fairly shared, it becomes easier to avoid beggar-thy-neighbor trade measures.
- The moratorium on new trade restraints agreed at the inaugural G20 summit should be reaffirmed through to the end of 2010 and given teeth. This would include explicitly endorsing the WTO's enhanced surveillance role for the duration of the crisis, and requiring the G20 to report immediately all changes in applied tariffs and subsidies to the WTO Secretariat. The reporting requirement should also apply to all

presumed WTO-legal measures under contingent protection, including safeguards, countervailing duties, and antidumping initiations and sanctions. The Secretariat would be required to report periodically to the WTO General Council as well as to provide a written account as a background paper to future G20 summits.

- International consultative groups should be established under the auspices of the G20 to monitor support to sensitive sectors, such as banks and automobile companies, to promote the minimization of trade distorting effect and to encourage such supportive measures to remain strictly WTO-legal. The purpose of these groups would be to exchange information, improve transparency, and agree on guidelines.
- The G20 should reaffirm its determination to bring the Doha negotiations to a successful conclusion by the end of 2009.

Policy Recommendations: Longer-term Measures to Reduce the Likelihood of a Resurgence of Protectionism in Future Crises

- The overwhelming priority of the G20 over the next year should be to reignite economic growth and avoid the spread of protectionism, by taking the steps just described. However, just as thought is now being given to strengthening the international financial architecture to prevent a recurrence of the financial crisis, including reform of the World Bank and the IMF, so consideration is required of how the international trading system can be strengthened to avoid a resurgence of protectionism in future crises. Since seven years of Doha negotiations have so far failed to produce even a modest improvement in multilateral disciplines, it is reasonable to ask how the WTO process can be made more effective. With this in mind, the G20 should endorse the launch of a working group to propose WTO reforms.
- Near-term questions to be addressed by the Working Group should include: a) how can the WTO's surveillance function be strengthened? b) How can rules on state aid in the event of macroeconomic crisis be clarified and strengthened? c) How can the membership of the plurilateral agreement on government procurement be broadened, ideally to cover the whole WTO membership?
- Longer-term questions, would relate to the functioning of the WTO as an effective negotiating body—one that, over time, can be realistically expected to reduce bound tariffs and subsidies, thus reducing the gap between bound and applied tariffs and subsidies, reduce the enormous room for discretion in trade in services, and also place tighter disciplines on contingent protection (safeguards, antidumping, etc.). These questions include: how can negotiations be made faster, more

capable of accommodating diverse interests of members, and more successful in addressing today's most pressing issues? Should negotiations be increasingly based on plurilateral and sectoral agreements rather than the single undertaking? How can the WTO draw on the energy of regional trading agreements, and better discipline and incorporate them, so as to make progress on overall trade liberalization?

Conclusion

Since its early manifestations in the middle of 2007, the severity of this crisis has been systematically underestimated. Many years of stable growth (the so called "Great Moderation") as well as a sense that the lessons of previous crises had been learnt induced complacency. Yet, many things that were difficult to imagine even a year ago are now happening, including a fall in world GDP, a near-collapse in world trade, double digit U.S. budget deficits, and the obliteration of mighty investment banks. The crisis may now be about to force policy makers to revise their view that open borders can be taken for granted. The virtually unprecedented intensity of this episode, the possibility that it will become protracted, the vastly expanding role of government in economic decisions, and the weakness of constraint mechanisms in trade policy—all underline the vulnerability to protectionist tendencies. Now is the time for policy makers to take bold steps to forestall a protectionist resurgence.

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Notes

1 Reinhart and Rogoff (2008)
2 Reinhart and Rogoff (2008)
3. Wolf (2009).
4 Reinhart and Rogoff (2008).
5 Hufbauer and Schott (2009).
6 Evenett (2008).
7 Lamy (2009).
8 Gamberoni and Newfarmer (2009).
9 Gamberoni and Newfarmer (2009).
10 Lamy (2009)
11 Gamberoni and Newfarmer (2009)
12 Gamberoni and Richard (2009).
13 Bouet and Laborde (2008).
14 Madsen (2001).

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