

## International Trade and Emerging Protectionism since the Crisis (ARI)

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**Theme:** Protectionism has returned, reversing an almost three-decade trend of trade liberalisation.

**Summary:** 2009 was a crisis year for international trade, which suffered its steepest decline since the 1930s. Protectionism returned, reversing an almost three-decade trend of trade liberalisation. But, contrary to expectations, it has *not* returned with a vengeance, rather creeping to the surface in subtle ways. Time, therefore, to take stock of trade policy after the crisis, and consider its outlook at the beginning of this century's second decade.

### Analysis:

#### *The 'Goldilocks' Global Economy Before the Crisis*

The pre-crisis global economy enjoyed golden conditions. The quarter-century up to the crisis saw the fastest increase in economic growth, globalisation and prosperity in history. International trade increased sevenfold between 1980 and 2008, outpacing the increase in world GDP in the same period. World foreign direct investment (FDI) far outpaced both, increasing almost thirtyfold. The global economy had its 'Goldilocks' moment in the half-decade from 2002. Growth, trade and FDI soared to ever-greater heights. Financial globalisation soared even higher.

Rapid globalisation had two driving forces: technology and policy liberalisation. The West had its Reagan, Thatcher and European Single Market revolutions in the 1980s and early 1990s. Developing countries liberalised massively and integrated into the global economy in the 1980s and 90s, with ex-Soviet economies following from the early 1990s. Average tariffs in developing countries fell from about 30% in 1985 to just above 10% in 2005.

#### *The Global Economic Crisis and 'De-globalisation'*

The financial crisis that exploded in September 2008 transformed a benign global political and economic context into something more malign. A sharp contraction in global growth ensued. This was reinforced by even sharper contractions in trade, FDI and other channels of globalisation. The world suffered its worst 'de-globalisation' since the Second World War.

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Contractions in growth, industrial output and trade bottomed out towards mid-2009, followed by a halting recovery. By year-end the latter remained anaemic and uncertain in the West, but Asia rebounded quickly. China led the Asian bounce-back, helping to lift other east-Asian countries out of the crisis, and India recovered fast as well. Thus the crisis seems to have accelerated the shift of economic gravity to the East. It has given rise to sunny Asian optimism, which contrasts sharply with Western gloom. Nevertheless, the global economic outlook remains uncertain, probably with turbulent times ahead. That Asia cannot escape. Moreover, Western *and* Asian –notably Chinese– policy responses to the crisis are storing up a lot of trouble (of which more later).

To put flesh on the bones of crisis-induced de-globalisation: the last IMF World Economic Outlook forecasts a decline of 1.1% in world GDP in 2009, split between a decline of 3.4% in developed economies and an increase of 1.7% in developing economies. The Asian Development Bank forecasts growth of 4% in developing Asia in 2009, going up to an almost tigerish 6.4% in 2010. China is expected to post growth of 8% or higher, and India 5%-6%, in 2009.

De-globalisation has been most dramatic in finance. International capital flows shrunk by 82% in 2008, and global wealth shrunk by US\$29 trillion in 2008 and the first half of 2009. The IMF forecasts the volume of international trade in goods and services to contract by 11.9% in 2009, split between a contraction of 14% in developed economies and 7% in developing economies. This is concentrated in trade in merchandise goods, linked tightly to the collapse of global industrial output in the last quarter of 2008 and the first quarter of 2009. Parts of trade in services suffered equivalently, especially transport (related to goods trade), financial services and tourism. But other services, mainly business and professional services, were much more resilient, even registering modest growth. According to UNCTAD, global FDI decreased by 15% in 2008 and is forecasted to decrease by an extra one-third (to US\$1.2 trillion) in 2009. UNCTAD expects migrants' remittances to fall by 5%-8% in 2009. The World Tourism Organisation projects international tourist arrivals to fall by 2%-3% in 2009.

#### *The Economic and Trade-Policy Outlook*

The global economic crisis has triggered a big shift in ideas and policies against free markets and in favour of government interventionism. 'Crisis interventions' are bunched in two key areas: (1) huge bailouts, especially but not confined to financial services; and (2) fiscal stimulus packages, usually combined with loose and unorthodox monetary policies.

Bank bailouts were probably unavoidable in the extreme conditions of late 2008. So were extra-loose monetary policies to inject a superdose of liquidity. But it is highly debatable whether massive fiscal pump-priming –Keynesianism on steroids– was necessary. Sceptics doubt the effectiveness of the Keynesian fiscal multiplier, especially in complex open economies (in which some of the extra demand leaks abroad through imports). Oceans of public debt will mean higher taxes and real interest rates, in addition to inflationary threats. Collateral damage will include crowding out of capital for emerging markets, as well as making it more expensive.

The *microeconomics* and *politics* of financial bailouts and profligate macroeconomic policies are at least as vexing. It is stupefyingly naïve to expect these measures to be well-targeted and effective, while avoiding arbitrary interventions, wasteful pork-barrel spending and long-term entitlements. This will stifle private-sector incentives to save,

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invest and innovate. It will restrict competition and raise costs for businesses and consumers.

One aspect of the new conventional wisdom is the belief in 'Keynes at home and Smith abroad'. Greater government macro- and microeconomic interventions at home are needed to stimulate recovery and preserve social stability –and thereby prevent a slide into protectionism–. But this should proceed in tandem with open markets abroad, which require robust international policy coordination (sometimes labelled 'global governance'). This idea is based on a contradiction. Big Government at home, with its discretionary power and panoply of competition-restricting regulations, will inevitably spill over into protectionism. Keynes at home is Keynes abroad. After all, Keynes turned to protectionism in the 1930s, not least to make activist fiscal policy work in a 'closed-economy' setting.

Here historical parallels are in order. It is fashionable to make comparisons between the recent crisis and that of the 1930s. But in one important respect this is highly misleading. Then, tit-for-tat trade protection rapidly followed the Wall Street Crash, and the world splintered into warring trade blocs. This has *not* happened today, and it is unlikely to happen anytime soon.

Rather the appropriate comparison is with the 1970s. Then, a series of shocks triggered more government intervention. New labour-market and capital-market regulations, subsidies, fiscal-stimulus packages and price-and-wage controls were all rolled out. These measures exacerbated initial crises and prolonged stagnation. But they also spawned protectionism. Industry after industry, coddled by government support at home, demanded protection from foreign competition.

The result was the 'new protectionism' and 'managed trade' of the 1970s and 1980s. Unlike 1930s-style protectionism, this was not an up-front declaration of a trade war with tariff hikes, blanket quotas and draconian foreign-exchange controls. Rather it was more subtle, deploying non-tariff barriers such as 'voluntary export restraints', 'orderly market arrangements', subsidies, public-procurement restrictions and onerous standards requirements. It did not spiral out of control; rather it unfolded slowly and insidiously, and lasted over a decade-and-a-half. It created overcapacity in several industrial sectors, and probably delayed global recovery and globalisation. That, not a melodramatic 1930s scenario, is the danger facing us today.

#### *Emerging Protectionism*

Perhaps the biggest surprise is that the world has not hurtled into tit-for-tat protectionism. According to the WTO, new trade measures since the crisis started affect a maximum of 1% of world trade in goods. New protectionism is concentrated in sectors that have long been protected: textiles, clothing, footwear, iron, steel, consumer electronics and agriculture. New anti-dumping, safeguards and countervailing-duty investigations have increased, but they still affect a tiny share of world trade. And up to one-third of new trade measures have been *liberalising*.

*Global Trade Alert* (GTA) paints a more alarming picture. It counts at least 297 trade-discriminatory measures since November 2008. And protectionism in the pipeline is trending upwards. It estimates that one-third of new protectionist measures are bailouts to financial services, automobiles and other sectors. Thus the good news on remarkably mild

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'traditional' protectionism (mainly border barriers) is balanced by worrying signs of non-traditional, behind-the-border protectionism.

'Financial mercantilism' is at the top of the latter list. One aspect of it is home-government pressure on bailed-out banks to 'lend local', ie, to lend at home at the expense of foreign lending (eg, through foreign subsidiaries). A second aspect is pressure from home governments and regulators to concentrate more financial trading activities at home, with accompanying restrictions on cross-border trade. Finally, regulatory proposals may end up with a *cordon sanitaire* around mammoth banks deemed 'too big to fail', with alarming implications for global competition as well as moral hazard.

There are other non-traditional protectionist instruments deployed in the wake of the crisis: first, industrial subsidies. These have gone overwhelmingly to the automobile industry. Direct support has gone to domestic firms and could well fall afoul of WTO disciplines on trade-distorting subsidies. Secondly, public-procurement or 'buy-national' restrictions. Third, restrictions on migrant labour. Fourth, FDI restrictions or 'investment nationalism'. Fifth, standards protectionism. Anecdotal reporting points to more restrictive application of technical and food-safety standards on imports since the crisis started.

But the climate-change agenda is set to be the Trojan Horse of new standards protectionism. Because cap-and-trade schemes, especially in the US and the EU, will impose substantial compliance costs on energy-intensive sectors at home, there will be more pressure to impose similar costs on cheaper, carbon-intensive production elsewhere not subject to carbon-reduction policies. Hence the spectre of trade sanctions on 'free riders' –China in particular–. 'Carbon tariffs' have been threatened. But climate-change protectionism could also include 'green subsidies' that discriminate in favour domestic producers, and all sorts of discriminatory standards.

The credit for restraining traditional protectionism should go to *markets* and *globalisation*, not to summitry and palaver in the G20, WTO and other international forums. G20 pledges not to increase protection have been serially broken. And WTO disciplines on developing countries, even on tariff bindings, are very weak. Rather, global market integration has imposed *spontaneous* disciplines on governments and businesses. They realise that up-front protectionism raises business costs, invites retaliation, excludes them from the benefits of globalisation and damages wealth and welfare at home.

More worrying is the non-traditional regulatory protectionism in the pipeline, on which WTO disciplines are weak to non-existent. The danger is that, if not contained, it will spread gradually to cover bigger swathes of international trade. That is the 1970s scenario to worry about.

#### *A Review of the Troops*

Now turn to the major players in trade policy and see how they have responded to the crisis.

Starting with the US, President Obama has powerful protectionist forces inside his tent, especially among Congressional Democrats and organised labour. His record to date shows a balancing act, giving way to domestic protectionist forces at one moment, but cushioning their impact and maintaining open markets the next moment. Nevertheless, this Administration's overall approach is defensive, and trade policy is very low down its list of priorities. Above all, the Administration is *not* leading with open-market initiatives,

and the President seems extremely disinclined to face down his union supporters and protectionists in the Congress. That is no surprise: a left-liberal Administration given to domestic intervention left, right and centre is not the sort to take the fight to protectionists at home and lead international cooperation to open markets worldwide.

This is bad news. The US is abrogating its traditional leadership role in world trade. It leaves a global vacuum, for there is no substitute leader to forge international cooperation to contain protectionism, open markets and strengthen multilateral rules –not the EU, not China, not anyone else–.

The EU is also in defensive mode. Generally, when the Single Market is opening up and integrating, EU trade policy is more outward-looking and proactive. When the Single Market is under stress from internal protectionism, EU trade policy turns to navel-gazing and gives way to protectionism against outsiders. That is roughly the situation today.

National crisis responses within the EU included the effective suspension of rules on state aid, which restricted competition from other member-states. The Lisbon Agenda of market reforms to boost EU competitiveness has been forgotten –one of the big casualties of the crisis–. Externally, trade policy is defensive. With the exception of the (yet to be ratified) FTA with South Korea, trade negotiations are stuck. True, the EU has not markedly increased traditional protectionism (eg, tariffs and simple non-tariff barriers), but there are signs of regulatory protectionism, especially on product standards (some of it to do with the EU's climate-change agenda). Finally, the Lisbon Treaty confers the European Parliament greater power in EU trade policy. Market-sceptical forces and single-issue fetishists in the EP may complicate decision-making and tilt policy outcomes in a more protectionist direction.

What about China? Liberalisation has stalled since about 2006, corresponding with more industrial-policy measures to promote selected sectors and 'national champions', mainly SOEs. China's crisis response –essentially an investment binge– bolsters the public sector and state power at the expense of the private sector. It has succeeded in arresting growth slowdown in 2009, but it exacerbates China's structural fault-line of over-investment and under-consumption. Its command-and-control mechanisms take market reforms backwards. And there is the real risk of surplus manufacturing capacity flooding into shrinking export markets in Europe and North America, thereby inviting protectionist retaliation against China.

Commendably, the Beijing leadership has not rocked the boat during the crisis: it has not resorted to aggressive mercantilism. But stalled trade and FDI liberalisation, the absence of domestic structural reforms and creeping protectionism threaten future trade tensions.

**Conclusion:** The global economic crisis has ushered in a new age of Big Government. Keynesian macroeconomics is back in fashion, as is Pigovian welfare economics – microeconomic interventions to fix alleged market failures–. A social-engineering mentality –the belief that superior technocratic minds can solve complex social and economic problems with targeted interventions– is in the ascendant. Welcome to the world-view of Mr Bentham. That of Messrs. Hume, Smith and Hayek (the belief that governments cannot possibly have enough knowledge to 'fine-tune' outcomes with detailed, prescriptive regulations; that they 'fail' through human fallibility, political pressure and corruption; and, consequently, that regulation should err on the side of caution to allow markets to operate effectively) is much less popular at the moment.

The short-term challenge is to arrest the slide to Big Government at home and creeping protectionism abroad. The medium-term challenge is to get back on track with trade and FDI liberalisation combined with domestic structural reforms. That is primarily a matter for *unilateral* action by governments and *competitive emulation* among them. It can be reinforced by international policy cooperation in the WTO, G20 and other forums, but not too much can be expected of cumbersome global-governance mechanisms.

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