

The fateful allure of protectionism: Taking stock for the G8

Blurb: Having reviewed the available evidence on the implementation of the G20 commitment to refrain from raising new barriers to trade and investment, this World Bank-CEPR report identifies four reasons why increased vigilance against protectionism is called for over the next 12 months.

1. Only a small portion of the stimulus package money has been spent so far. As government expenditure will be directed towards local economic activity, the incentives for trading partners to respond in kind and discriminate against foreign firms and products may rise.
2. Even the most optimistic forecasts for economic recovery imply substantial increases in unemployment in the major trading powers in 2010 and, in some cases, in 2011. In fact, the unemployment rises experienced to date are smaller than that expected in the coming year. Rising unemployment has long been associated with government resort to protectionist measures. The protectionist temptation will almost surely intensify before it abates—a finding that will hold even if the much vaunted "green shoots" do emerge into recovery.
3. Many governments now have little margin for maneuver in fiscal and monetary policy, and in the event that the recession persists, they could resort to trade and industrial policies as a stop-gap.
4. A significant increase in the use of trade-distorting policy by a major jurisdiction could set off unwelcome domino effects, not unlike that witnessed for auto subsidies, dairy export subsidies, and procurement nationalism in the last few months.

Principal Findings and Policy Recommendations

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1. The context

The world is facing the most severe global economic crisis since the Great Depression of the 1930s. For the first time since World War II, in its projections for annual economic growth published last week the World Bank expects world GDP will decline (-2.9% in 2009) and developing countries growth will fall to 1.2% from 5.9% in 2008.¹ Excluding China and India, other developing nations' economies will shrink on average by 1.6%. Net private capital flows to

¹ All data reported are from World Bank, *Global Development Finance, 2009*.

developing countries will likely turn negative in 2009 – a more than \$800 billion drop from the 2007 peak. The decline in global foreign direct investment (FDI) flows that started in 2008 will deepen and spread to the developing world – with overall inflows projected to fall some 30% compared to 2008, the first time FDI has fallen more than 10% in a year since 1986. The value of remittances, perhaps the most stable source of external financing for developing countries, is expected to drop by 5% this year.

Trade is no exception. Global trade volumes are expected to decline by some 10% in 2009; the worst decline in trade since the 1930s. While all regions in the world are severely affected, the impact of the decline is stronger in countries that are highly dependent on trade with developed countries where demand has contracted most. For example, in Cambodia, which relies heavily on tourism and exports of garments to the US, growth fell from 10.2% in 2007 to 6.7% in 2008 and the economy is expected to decline by 1% in 2009.

Governments have responded to the crisis with large fiscal stimulus packages and central banks around the globe have engaged in far-reaching monetary easing. The objective has been to support demand and thus economic activity and employment. Efforts have been made to coordinate policy responses, through the G20 and other fora, including in the area of international commerce. Maintaining an open trade regime is an important part of the path for getting out of the crisis. At the April 2, 2009 London Summit, the G20 countries committed to refrain from raising new barriers and to minimize any negative impact on trade and investment of domestic policy responses to the crisis (Box 1). This recognizes the importance of not taking measures that discriminate against and between foreign providers of goods and services, so disrupting further the commercial playing field. The systemic risks of a significant resort to protectionist policies are generally recognized by world leaders. The 1930s, as well as the more recent extensive resort to protectionism (‘voluntary’ export restraints for cars, quotas on textiles and steel) during the early 1980s recession, illustrate that if some major countries put in place measures to close domestic markets, the risk of others following is high. At present the greatest threat to the world trading system is that—through accident or design—a major trading nation decides to turn inward and reject global economic engagement.

Box 1: Paragraph 22 of London Summit Communiqué, 2 April 2009

World trade growth has underpinned rising prosperity for half a century. But it is now falling for the first time in 25 years. Falling demand is exacerbated by growing protectionist pressures and a withdrawal of trade credit.

Reinvigorating world trade and investment is essential for restoring global growth. We will not repeat the historic mistakes of protectionism of previous eras. To this end:

- we reaffirm the commitment made in Washington: to refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organisation (WTO) inconsistent measures to stimulate exports. In addition we will rectify promptly any such measures. We extend this pledge to the end of 2010;
- we will minimise any negative impact on trade and investment of our domestic policy actions including fiscal policy and action in support of the financial sector. We will not retreat into financial protectionism, particularly measures that constrain worldwide capital flows, especially to developing countries;
- we will notify promptly the WTO of any such measures and we call on the WTO, together with other international bodies, within their respective mandates, to monitor and report publicly on our adherence to these undertakings on a quarterly basis;
- we will take, at the same time, whatever steps we can to promote and facilitate trade and investment; and
- we will ensure availability of at least \$250 billion over the next two years to support trade finance through our export credit and investment agencies and through the MDBs. We also ask our regulators to make use of available flexibility in capital requirements for trade finance.

2. What we have observed so far

This volume summarizes the findings of a set of papers presented at a joint World Bank-CEPR conference in May 2009 that assessed the prevalence and cross-border effects of the different policy responses put in place by governments to the crisis.² The conclusion that is suggested is “so far so good,” or to paraphrase Josling and Tangermann in their contribution on agricultural trade policy, so far the protectionist “dog did not bark.” Although there is much heterogeneity in terms of policy responses, and a growing number of countries have put in place some protectionist measures, to date we have not observed large scale increases in the level of discrimination against foreign suppliers of goods and services by major trading states. Indeed some countries, including Mexico, have responded by reducing tariffs and other barriers to trade.

A stylized fact that is suggested by the evidence to date and the analyses in the papers included in this volume is that where multilateral disciplines exist, recourse to protectionism has been limited. Some countries have utilized the ‘policy space’ they have to raise tariffs, but projections – based on past behavior – are that any such increases are likely to remain limited: Olarreaga and others predict increases in 2009 of perhaps 8 percent. In the area of agriculture, Josling and Tangermann stress that reactions to the crisis have been relatively muted, and good news (tariff reductions, removal of import bans and export taxes) coincides with bad news (tariff increases, reactivation of export subsidies). In a sector that in the 1970s and 1980s became a bastion of protectionism, textiles and apparel, Frederick and Gereffi argue that policy remains very open. Another illustration of this stylized fact is that countries that are not WTO members are among those that have made the most intensive use of measures to restrict trade and investment – e.g., Algeria, Bosnia, and Russia.

Insofar as protectionist actions are being pursued, many are taking the form of measures permitted by the WTO, especially antidumping and (selective) safeguard actions. While such measures are discriminatory and clearly inconsistent with the letter (and spirit) of the G20 declaration, they are relatively transparent and in principle are constrained by multilateral rules. Indeed, these instruments are often described as ‘safety valves’ that need to be included in trade agreements in order to give governments the assurance that in times of need – as is the case today – they will be able to re-impose a certain level of protection if this is needed for political purposes. While the use of trade policy is second-best – fiscal and monetary policy is more effective and efficient – using instruments of contingent protection to manage pressures for restricting imports in specific sectors is typically superior to a government having recourse to nontariff barriers (such as VERs in 1980s). In his analysis of the use of these WTO ‘trade remedies’ Bown notes there has been an 18.5 percent increase in the use of antidumping, safeguards, and countervailing duties, including by almost all the G20 countries. These actions increasingly affect “South-South” trade, and primarily target exports from China. However, the amount of imports targeted by these measures thus far remains relatively small: less than half of one percent of the total merchandise imports of G20 countries. The number of measures taken is still below what it was only a few years ago, suggesting that with the exception of a small number of countries – such as India – the overall use of these instruments remains limited.

A second, and related stylized fact emerging from the papers is that where no multilateral disciplines exist, or where they are weak and limited in coverage, countries have been less able to resist protectionist pressures. The reintroduction of export subsidies by the United States and the European Communities (EC) are high profile examples of this point; high profile precisely

² The conference was financed in part by the Global Trade and Financial Architecture project, an initiative that is supported by the UK’s Department for International Development.

because these subsidies are thought to have harmed many developing countries' commercial interests in the past. According to globaltradealert.org, 80 jurisdictions export the commodities for which the U.S. has reintroduced export subsidies.³ The comparable number of affected exporting jurisdictions for the EC's export subsidies was 41.⁴

In his paper, Claessens stresses that the absence of adequate multilateral disciplines and mechanisms for cooperation in the area of finance services gave rise to nationalist solutions, distorted resource allocation decisions and undermined conditions of competition. Similarly, the lack of multilateral disciplines on the movement of natural persons providing services implies that countries are free to unilaterally redefine the rules of the game and (re-)introduce barriers to the local employment of foreign professionals. Malaysia, the United States, and the United Kingdom have done just that in the past 6 months.⁵ The absence of any disciplines in the WTO on measures that affect the export of services implies that source countries are free to take actions that have the effect of raising the costs and/or reducing the flow of financial services.

In his paper on stimulus packages and public procurement, Evenett notes that WTO disciplines in this area have limited coverage and that local (sub-national, municipal) governments may be free to require that funds be spent on domestic firms' raw materials, parts and components. A number of examples of explicit discrimination can be found in the implementing regulations of the American Recovery and Reinvestment Act at the state and local level. Similar provisions have been adopted in Australia by New South Wales and most recently it is said by China – neither of which is bound by the relevant WTO disciplines on procurement because they have not signed the Agreement on Government Procurement.⁶

The policies in these areas are potential examples of so-called “murky” protectionism (Baldwin and Evenett, 2009), where damage to foreign commercial interests is the consequence of the non-transparent application of discretion given to regulators and line ministries. This type of protectionism is at first cut difficult to identify, and harder to quantify. For example, it could be the strings attached to bailouts received by automobile producers in Europe. All too often, the devil is in the details of implementation rather than the umbrella legislation. This suggests that there is an urgent need to monitor closely what all government bodies do, not just those central entities that are subject to international trade disciplines. In his contribution to this volume, Jenny argues for a systematic assessment of the impact on competition of all the policy responses to the crisis. This is particularly needed for those state policies which are promoted as serving some unobjectionable objective but where the implementation details suggest that competition and market forces are unduly distorted.

Beyond this, given that countries appear to be abiding by WTO commitments where these apply, the problem is that there are no multilateral disciplines in these areas (financial sector; fiscal stimuli) or countries have not committed themselves to abide by them (procurement, services trade). Ultimately this suggests a priority for governments is to (re-)engage in negotiations to

³ See <http://www.globaltradealert.org/measure/united-states-america-dairy-export-incentive-program>.

⁴ See <http://www.globaltradealert.org/measure/ec-reintroduction-export-refunds-milk-butter-and-butteroil>

⁵ See the reports on these measures on globaltradealert.org, the CEPR-led portal for online monitoring of trade-related measures taken during the current global economic downturn.

⁶ This Agreement is one of two agreements in the WTO where participation is voluntary. Almost all developing countries and some OECD countries have not signed the procurement agreement. The reason a separate agreement is needed in the first place is that the WTO does not cover public procurement—i.e., the basic nondiscrimination rules (MFN and national treatment) do not apply to government purchases of goods and services.

establish such disciplines. Indeed, the resort to discriminatory state policies during this sharp global economic downturn could—and should—help define the commercial policy priorities for governments in the early twenty-first century.

3. Factors explaining the limited use of trade policy to date

Although many countries have imposed protectionist measures, there has not been much in the way of tit-for-tat retaliation. A number of factors explain why, so far, protectionism seems to have been contained. As Irwin stresses in his contribution, the foremost reason that countries have been able to avoid repeating the experience of the 1930s is because of their willingness to rely on expansionary monetary and fiscal policy. In the 1930s these instruments could not be used to the same extent due to the gold standard and balanced-budget orthodoxy.

Another important factor is the extent of globalization of production that has occurred in the last 20 years or so. For many companies (and thus governments) this has changed the incentives to seek protectionist policies. Maintaining an open trade regime is in the interest of firms that are part of global supply chains, as closure would substantially raise costs and undermine competitiveness. This helps to explain why many of the countries that have taken overt protectionist action tend to be less integrated in global supply chains (e.g., Algeria, Argentina, Ecuador, India, Russia). It may also explain why firms have sought bail-outs and subsidies rather than tariff increases from their governments. (Plus, tariff increases are not much use to a firm that sells little to the market in which it is operating or where a sharp economic downturn has cut into the customer base substantially. Much better to obtain a direct fiscal transfer—a subsidy—if it is available, rather than wait for a tariff to reshuffle what customers remain from foreign goods to goods produced domestically.)

A third factor is the WTO, as well as deep regional integration agreements such as the EU and the web of bilateral investment treaties. There are now binding international disciplines that go some way to deter countries from violating the national treatment principle. As mentioned above there is a negative correlation between the use of restrictive trade policy and WTO disciplines in the relevant areas. Should the number of WTO and investment disputes increase substantially as the crisis unfolds, then this finding may need to be nuanced. Still, it would demonstrate that governments are resorting to official dispute settlement procedures and not taking matters immediately into their own hands.

There is also a willingness to build on and use the multilateral trading system as a tool to fight the crisis. The ability to pledge over \$250 billion over the next two years to boost trade finance is an example. Another is the engagement by the WTO to actively and publically monitor the use of policies by its members, increasing transparency and stimulating peer pressure with regard to the design and implementation of potentially harmful policy responses to the crisis.

4. Worrisome trends call for increased vigilance, now and in the future

The monitoring work of the WTO and other organizations, including the World Bank, has revealed some worrisome trends that could strengthen if the crisis lasts and deepens. The crisis has put governments under severe pressure to assist domestic industries and support employment. It is too early to know whether the worst of the decline in economic activity is behind us. But even if the crisis is now bottoming out, the prospects are for a slow recovery. This implies that governments will remain under pressure for some time to take actions to support local economic activity.

A number of considerations all call for increased vigilance over the next months.

1. Only a small portion of the stimulus package money has been spent so far, and implementation may produce further discrimination. As trading partners realize the growing level of discrimination, the temptation to ‘retaliate’ may grow.
2. Even the most optimistic forecasts for economic recovery imply substantial increases in unemployment in the major trading powers in 2010 and, in some cases, in 2011. In fact, the unemployment rises experienced to date are smaller than that expected in the coming 12 months. Rising unemployment has long been associated with government resort to protectionist measures. The protectionist temptation will almost surely intensify before it abates—a finding that will hold even if the much vaunted "green shoots" do emerge into recovery.
3. Many governments now have little margin for maneuver in fiscal and monetary policy, and in the event that the recession persists, they could turn to trade and industrial policies as a stop-gap resort.
4. A significant increase in the use of trade-distorting policy by a major jurisdiction could set off unwelcome domino effects, not unlike that witnessed for auto subsidies, dairy export subsidies, and procurement nationalism in the last few months.

While there is clear need for continued vigilance in the coming months, the crisis has also revealed significant weaknesses in the WTO transparency and notification mechanisms. Monitoring of policies has shed a new light on the limited extent of information on discriminatory application of policies, whether or not subject to WTO rules. There has been substantial “slippage” in the global trade system towards more discrimination in recent years and some complacency regarding breaches of the non-discrimination principles that are the core of the WTO system. Elements of this slippage include the spread of preferential trade agreements, both reciprocal and unilateral, and selective safeguard actions. The general trend away from MFN – part of the status quo ante – has received considerable attention in the context of the crisis as a result of the fear of repeating the historic mistakes of protectionism. This suggests the crisis may have a silver lining for the trading system – it may revive interest in, and support for, pursuit of multilateral cooperation.

5. Policy implications and recommendations

Resisting the protectionist temptation is not a matter of luck or chance. Beyond declarations of good intent, concrete steps toward reinforcing the global trade system are needed.

The crisis has revealed that rules matter: WTO disciplines appear to have played a positive role in constraining recourse to protectionism. This makes rapid conclusion of the Doha Round important. The responses to the crisis clearly illustrate that a multilateral trade negotiation should not be assessed only on the basis of how much new market access opportunities it generates. This has been the metric used by many lobbies, analysts and the press, as well as some key negotiators. It is misconceived. The primary role of the WTO is to set the rules of the game and to lock-in the policies of members.

As the crisis continues, the opportunity cost of inaction on Doha rises. A common conclusion from the contributors to the World Bank-CEPR workshop is the need to rapidly conclude the Doha round. This would limit the ability of governments to increase tariffs or agricultural

subsidies in the future, send a strong signal of the international community's commitment to keep trade and investment flowing and help countries resist pressures for protection when they begin to unwind their current expansionary policies. The value of "what's on the table" has increased as a result of the crisis.

Concluding Doha is also important as critical policy matters outside the Doha Development Agenda need to be addressed. The lack of agreement on the Doha Round is crowding out the prospects for cooperating on initiatives that address large cross-border knock-on effects. Climate change is the most obvious example where there is an urgent need for governments to consider the implications for the trading system of concerted action to reduce carbon emissions and green house gas emissions. Finishing the Doha Round is a precondition for addressing some of the weaknesses in the global trade and financial architecture that the crisis has revealed.

Government responses to the current global economic downturn have other implications for the multilateral trading system. First, the areas where "murky" protectionism has emerged suggests that there is a need to expand the scope of multilateral cooperation. Potential areas for negotiating rules of the game include competition policy, public procurement, other non-tariff barriers, service-sector regulation, and subsidies, including investment incentives. "Murky" protectionism is just one facet of a fundamental mismatch between trade rules that were designed in the early 1990s or earlier and contemporary regulatory priorities as they relate to the global trade and financial system.⁷ The absence of international rules in these areas allows discrimination to be pursued with impunity.

Second, "murky" protectionism may not be just a crisis phenomenon. The monitoring work and related analysis revealed that very little is known about the distribution of local government procurement and what share of purchases is allocated to local firms. The same is true of subsidies and many nontariff policies. In part this is a reflection of the absence of multilateral disciplines, so that there is no need to report or to collect the requisite data. In part it is a reflection of the fact that WTO members are simply not living up to their existing commitments in the area of notifications and transparency.

At a minimum, recent monitoring exercises suggest that the WTO notification and review mechanisms have been both neglected and inefficient. It is important to increase monitoring and public reporting efforts, so that government measures that could negatively affect trade and investment – whether compatible or not with WTO rules – can be identified more systematically and at an earlier stage. Transparency is one of the best defenses against rampant protectionism.⁸ Predictability and security of transactions remain the main drivers of global trade and investment.

The papers by Steenblik (on 'green protectionism') and Borchert and Mattoo (on services) illustrate that, whether or not policies are subject to disciplines, it is important that there be regular monitoring of government policies that may have major cross-border spillovers and analysis of their impact and incidence. In some policy areas there is much information – see e.g., Wyplosz and Weber's observations in their paper on exchange rate policies – but in others we are very much in the dark. Beyond ad hoc monitoring mechanisms, it is necessary to strengthen institutional notification and review mechanisms, such as on subsidies, competition, public

⁷ It being recalled that the prevailing multilateral trade accords were negotiated on the basis of an agenda set in 1986! Those born in that year are now old enough to drive cars and vote.

⁸ The desire to provide high quality information that could be used to add peer pressure on governments was an important rationale for the CEPR to launch Global Trade Alert, an independent online trade monitoring service at www.globaltradealert.org. The World Bank is one of five sponsors of this initiative.

procurement, non-tariff measures, or services trade policies. This will require dedicated resources, both financial and political, as the data will need to be collected and compiled.

Third, while many government policy responses to the crisis may be temporary, the effects of “buy national” or “buy local” could prove enduring if they result in emulation. It is noteworthy for example that some of the countries that are engaging in “buy national” policies are among those that have been most interested in seeing developing countries accede to the Agreement on Government Procurement. The signal that is being sent may have long term negative consequences for the realization of this objective. The same is true of actions by governments to restrict access to local services markets for foreign nationals, especially those countries where the demographics point to a greater need for foreign workers in the future. The longer-term costs of short-term policies may be significant if it results in future suppliers (trading partners) requiring a ‘risk premium’ to supply services. It was amidst strained circumstances, in 1943-1944, that the architecture of the post-war world economic order was established. There should be no delay on taking action to begin to remove discriminatory and trade-distortive measures that have been adopted to respond to the crisis.

Finally, it would be short-sighted to yield ground to protectionism. The crisis is stimulating innovation by firms and in so doing creating new trade opportunities. Eventually the crisis will end and once the recovery starts the more open economies will be better placed to benefit from the increase in demand. From this perspective, it is particularly important that efforts continue to focus on enhancing the competitiveness of firms and farmers in low-income countries by, inter alia, actions to lower trade and transport costs. In general, sustaining efforts to expand the delivery of “aid for trade” and achieving the commitments that were made in this regard at the 2005 WTO ministerial meeting in Hong Kong should be a priority, as they will help developing countries to benefit more from the recovery.

References:

Baldwin and Evenett (2009). Richard Baldwin and Simon J. Evenett. *The Collapse of Global Trade, Murky Protectionism, and the Crisis: Recommendations for the G20*. www.voxEU.org