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Protectionism during recession – why are trade barriers no longer the preferred policy choice?

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Abstract

Based on the experience of the Great Depression, when barriers to trade rose precipitously in a beggar-thy-neighbour trade war, a similar spate of increases was forecast by some as the global economy descended into the biggest economic downturn since the 1930s in the wake of the financial crisis of 2007. The evidence to date, however, shows no major swing to protectionist trade policy by governments in the world's major trading nations. In this paper, we assess the importance of trade policy in crises management and resolution and we investigate the main reasons for the absence of protectionist policies in the wake of the latest financial crisis.

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1. Introduction

Many parallels have been drawn between the deep recession which started with the financial crisis of 2007 and the Great Depression of the 1930s. Two of the consistent messages from those who studied the Great Depression and its aftermath were: (1) that protectionist pressure would become particularly virulent as economies contracted and; (2) that the increased protectionism of the 1930s, while it did not cause the depression, made the economic malaise of the 1930s both deeper and particularly longer than it otherwise would have been. The trade barriers put in place during the depression proved hard to remove and some persist today.

During the Great Depression, there were various attempts to find a cooperative solution that would lift the world economy from the depression. One of them was the World Monetary and Economic Conference held in London in June 1933, which was organized by the League of Nations. Sixty-six nations gathered to discuss the future of the world economy, but the conference collapsed due to the American opposition to the European idea of returning to a fixed exchange system. The result was more protectionism and economic hardship. In contrast, the leaders of the Group of Twenty (G20) declared in the Summit on Financial Markets and World Economy held in Washington on November 15, 2008 that "we underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty." (G20, 2008). Did they mean it? Had the world really changed since the 1930s? The UK Prime Minister Gordon Brown recalled the 1933 conference in March 2009, one week before a G20 summit,

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hoping that the history would not repeat itself and that the leading developed and developing economies would be able to find a way out of the worst global financial and economic crisis since the 1930s (Reuters, 2009).

In his annual report on trade and trade-related developments for 2009, Pascal Lamy, the Director General of World Trade Organization (WTO), stated that “although there have been instances of slippage, in general terms the world economy is about as open for trade today as it was before the crisis started.” He asked the WTO members “to devise and announce exit strategies to remove trade restrictions and production subsidies that they have introduced temporarily to counteract the effects of the crisis, and start implementing those strategies as soon as domestic economic recovery takes hold.” (WTO, 2009) The WTO’s 2009 assessment suggests that new protectionist measures affect a maximum of 1% of world trade in goods and services, while between November 2009 and May 2010, only 0.4% of trade was impacted by additional import restricting measures. However, subsequent WTO assessments indicate an increase in potentially trade restrictive measures, which would affect 0.8 percent of trade during the period June 2010 to October 2010 and 0.53 percent of trade from mid-October 2010 to April 2011. These were primarily border measures and export restrictions (WTO, 2011). Such a muted trade policy response to the economic downturn that followed in the wake of the financial crisis is both laudable and unexpected.

The paper is organized as follows. We will first briefly discuss in Section 2 the main causes and government responses to the financial crisis as well as the economic and trade implications that followed it. An assessment of the importance of trade policy in crises management and resolution is then provided. Section 3 presents the main reasons for the absence of protectionist policies having been observed in the wake of the latest financial crisis. The paper ends with a summary and conclusions.

2. The global financial and economic crisis of 2007

The origins of the late-2000s global recession can be traced to the 2007 financial crisis. In the pre-crisis period, the global economy enjoyed a spurt in economic growth, prosperity and globalization. Following a long period of economic boom, in 2007 a financial bubble burst. The collapse of US sub-prime mortgage market, the reversal of the housing boom in most developed countries and other weaknesses of the global financial system, such as government regulations failing to keep pace with financial innovation (Loppacher and Kerr, 2006), had a large impact around the world. As a result, major financial institutions started to incur heavy losses and the increased risk on the part of lenders constrained credit flows to businesses, consumers and banks. The situation was worsen by the failure of Lehman Brothers investment bank in September 2008, which combined with further decreases in housing prices and a decline in equity values led to reduced consumption and investment. The decline in aggregate demand caused world output and trade to contract sharply between the last quarter of 2008 and the first quarter of 2009. The latter was aggravated by reduced trade financing.

One of the consequences of what has become known as the biggest global financial crises since the Great Depression was a large decline in the world trade flows. The severe decline in trade between the third-quarter of 2008 and the second-quarter of 2009 represents the steepest falling off of global trade since the 1930s (by 15% for at least two quarters in a row) (Baldwin, 2009). The sharp decline in trade took place simultaneously in the major trading regions (exports: 14.8% drop in EU27, 14.4% in North America and 11.1% in Asia; imports: 14.5% drop in EU27, 16.3% in North America and 7.9% in Asia) (WTO, 2010). After a 12.2% drop in 2009, the WTO expected trade to grow by 9.5% in 2010 (WTO, 2010). Global trade declined 4.8 times more than the relative decline in GDP (Baldwin, 2009). Recent research has focused on the trade impacts of the global crisis in 2008. However, none of the researchers blame the trading system and protectionist measures for the collapse in trade.

Trade flows are also influenced by changes in exchange rates. In September 2008, the US dollar appreciated against other currencies, but between March and October of 2009, it fell by 12% against a basket of currencies and by 15% against the Euro. Most commodity prices have subsequently risen, the most important of these being crude oil prices, which rose by the end of 2009 to US$80/barrel from US$40/barrel in February of 2009 (WTO, 2009).

Governments around the world have reacted to the global financial and economic crisis by implementing different macroeconomic and trade policies. According to WTO, the new import restrictions implemented between October 2008 and October 2009 cover a maximum of 1% of global trade flows, while from Mid-October 2010 to April 2011 only 0.53 percent of trade was affected (WTO, 2011).The trade restrictions are comprised of increases in tariffs, the introduction of some new non-tariff barriers (NTBs), stricter application of Sanitary and Phytosanitary (SPS) measures and Technical Barriers to Trade (TBT) regulations and slower and additional customs procedures. Most of the trade restrictions are limited to a number of sectors that are chronically protected by governments such as agriculture, iron and steel, textiles and clothing, footwear, electronics, chemicals and plastics and motor vehicles. Other types of measures that have an influence on trade are represented by fiscal stimulus and bail-out packages. Concerns were raised because of buy/hire local requirements of these packages. The crisis did not trigger significant new market access barriers in trade in services. One concern that was expressed relates to the protection of local labour markets through increases in barriers to international migration.

Most developed countries and some developing countries have put in place different fiscal stimulus and bail-out packages. The fiscal packages can have small trade effects if we consider, for example, tax cuts or large trade effects as “buy local” requirements for government procurement schemes. “Buy national” requirements raise a number of concerns regarding trade. Firstly, it excludes foreign suppliers from the market; secondly, it may increase the costs of domestic producers in countries implementing such regulations; and, thirdly, it can lead to retaliation. For example, the “buy national” or “buy American” requirement of the US stimulus legislation was followed by “buy Chinese” regulations.

Along with the banking sector, the automobile industry has received the most support through bailouts and scrapping schemes. The support to specific sectors took the form of consumption and production subsidies and in some instances export subsidies in agriculture. The stimulus packages and the state aid resulted in high involvement of government in industries in crisis. However, the quantity of state aid and stimulus packages has declined as some countries move to terminate their stimulus programs.

3. Why no trade protectionism?

Protectionist interests have been alive and well during the late 2000s, but they have not been able to obtain any significant degree of additional protection. The expectation that they would be successful in having trade barriers raised – based on the experience of the 1930s – is premised on two assumptions: (1) that nothing was learned from the experience of the 1930s and; (2) that the economic environment is similar to that of the depression era. It will be argued that neither of these assumptions holds true and, hence, the experience of the Great Depression actually provides little insights pertinent for trade policy making in the recession of the late 2000s.

Policy makers did learn from the Great Depression and, using that knowledge took action to ensure that the lessons would not be lost. In this, the lessons of the 1930s were bundled together with those of the Second World War. The victors in the Second World War – and particularly the United States and the United Kingdom – perceived that a lack of international coordination and communication was a major contributor to the second global war in the span of little more than a generation – and they set out to remedy this deficiency. They perceived that there were four major sources of state-to-state conflict: (1) political confrontation; (2) strategic devaluations; (3) large differences in national wealth and incomes and; (4) beggar-thy-neighbour trade wars. Prior to the Great Depression there were no international organizations to deal with conflicts in the latter three sources of international conflict. Only in the case of political conflict had any attempt at international coordination and communication been attempted – the ill-fated League of Nations. As an institution, the League of Nations had some obvious deficiencies. The victors began to rectify what they perceived as a flawed international order in a very deliberate way. For political conflict they attempted to rectify the deficiencies of the League of Nations with a new organization, the United Nations. During the Great Depression, countries engaged in strategic devaluations which resulted in increased barriers to foreign trade to offset the effects of devaluations and to support failing sectors. This pressure for the imposition of trade

barriers has been reduced through the formation of the International Monetary Fund (IMF). Thus, the IMF limits devaluations by helping countries with currency problems through the offering of financial assistance conditional on various policy reforms. To deal with differences in levels of development they created the International Bank for Reconstruction and Development (IBRD) – or as is has come to be known, the World Bank. Finally, to prevent beggar-thy-neighbour trade wars an International Trade Organization was negotiated.

The International Trade Organization, however, never came into being (Kerr, 2010). One of its sub-agreements – the General Agreement on Tariffs and Trade (GATT), however, did come into being and became the *de facto* multilateral trade organization until it was rolled into the new World Trade Organization in 1995. Central to the GATT rules was a set of institutional obligations to prevent a recurrence of the beggar-thy-neighbour trade wars that took place in the 1930s – bound tariffs, non-discrimination, transparency, accepted retaliation (Kerr, 2000). Over the 60-years since the GATT came into being these obligations have remained constant but have been added to and strengthened so that countries are constrained in their ability to respond to protectionist pressure by a web of international obligations. Outlets for protectionism do remain – through antidumping, unfair subsidy and safeguard actions, but each of these has tight institutional procedures that prevent their use as a means to raise the level of protection on a broad basis.

Hence, the institutional constraint put in place after the Second World War to prevent a recurrence of the trade war of the 1930s appears to have performed well in its first major test. Of course, not all of the restraint in the use of trade policy in the recession of the late 2000s can be attributed to the GATT/WTO. In the 1930s there was no equivalent to the G-8 (or G20) where the political leadership meets face-to-face to coordinate economic policy. At the G-8 and G-20 meetings, the leaders have repeatedly pledged to restrain their country's use of trade measures.

The other major change since the 1930s is in the general economic policy environment. The period leading up to the Great Depression was one where governments had a limited role in the economy. Governments generally did not engage in industrial policy, did not have employment policies and were not engaged in the provision of welfare. Balancing the budget was the macroeconomic philosophy and, faced with declining tax revenues as their economies contracted, governments cut their expenditures thereby contributing to the decline in demand that was devastating their economies. In this era of small government, trade policy was one of the few economic leavers available to governments. They pulled that leaver in a desperate (but ultimately futile) attempt to save jobs.

The Great Depression and the inability of the prevailing thinking about economics to offer solutions led to a radical shift in economic theory. The influential book by J.M. Keynes, *The General Theory of Employment, Interest and Money* published in 1936 was immensely influential and set off, over time, a shift to big, interventionist government. The heart of what was to become Keynesian economics is that, faced with a recession induced decline in demand, governments should intervene to offset the decline because neither consumers nor investors would rationally increase their spending. Once an expanded role for government in the economy was accepted, the activities of government expanded rapidly into a vast array of industrial and social policies. The move into industrial policy led to a general acceptance of subsidization of firms as a policy option for governments. Although it has been widely criticized, governments *picking winners* and subsidizing them has become a central element of government policy in almost all modern market economies. In economic downturns this translates into *bailouts* of struggling firms.

Thus, unlike the 1930s, struggling firms could ask their governments for a variety of forms of assistance – not simply trade policy. While trade policy was one avenue for firms to pursue, subsidies are another route. While subsidies can distort trade, the international disciplines on subsidies in the WTO are much weaker than those that apply to border measures. The subsidies given to firms during the recession of the late 2000s were not put in place to gain a trade advantage but to stave off bankruptcy and, while countervailing duty actions have increased, they have not become a wholesale rush (Kerr, 2009). If the subsidies do not turn out to be temporary then one could expect more widespread initiation of unfair subsidy actions. Many of the stimulus package subsidies initiated by countries are targeted. The targeted sectors tend to be in infrastructure expansion – from roads to sewers to local amenities –

and construction; sectors whose goods are non-tradable so that the distortions to trade tend to me minimal. Another form of subsidy during the latest economic recession is represented by the quantitative easing that the central banks engaged at the request of governments in the US, UK and the Eurozone. Quantitative easing is a different monetary policy through which central banks buy financial assets from commercial banks and private firms with the goal of injecting money into the economy. Thus, undeserving firms may be propped up by central banks when, in reality, they should shut down. The rapid expansion in the role of government since the 1930s – from forty to fifty-plus percent of GDP in most developed countries means that government procurement has become far more important. Governments can use discriminatory procurement policy to assist domestic industries to the detriment of foreign suppliers of similar goods and services. Again, given the small role of government in the economy in the pre-Keynesian era, manipulation of government procurement was not a policy substitute for trade policy.

Thus, it is not that those requesting assistance from the government have disappeared during the recession of the late 2000s, it is just that they have alternatives to trade policy when seeking support from governments. In a relative sense, the use of trade policy measures is much more encumbered with international obligations than either the use of subsidies or government procurement. The recession that commenced in the wake of the financial crisis of 2007 has not fully been played out at the time of writing – April 2012 – so it is too early to fully conclude that the international trading system will largely escape from it unscathed.

4. Conclusions

Based on the experience of the Great Depression, when barriers to trade rose precipitously in a beggar-thy-neighbour trade war, a similar spate of increases was forecast by some as the global economy descended into the biggest economic downturn since the 1930s in the wake of the financial crisis of 2007. The evidence to date, however, shows no major swing to protectionist trade policy by governments in the world's major trading nations. The recession of the late 2000s was the first real test of this aspect of the GATT/WTO mandate. By and large, governments have lived up to their GATT/WTO obligations that constrain the use of trade policy. However, the GATT/WTO alone would not have been sufficient to curb vested interests lobbying for assistance through protectionist trade policies. The experience of the Great Depression also led to a major re-think of macroeconomic policy and, subsequently, a major expansion in the role of government in the economy. The Keynes-inspired shift in the macroeconomic paradigm set off a major (but unintended) expansion in government involvement in the economy. Unlike the 1930s when governments' policy options to assist firms were largely confined to trade policy, in the 2000s the granting of subsidies and government procurement policy were much less constrained than the use of trade policy – and governments responded in their stimulus packages with subsidies and provisions on government procurement rather than restrictions on trade.

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