

Weekly Report

International Trade Under Threat: Stopping Protectionism through Institutional Reforms

The global economic crisis has led to a massive increase in unemployment, and nearly all governments have declared the protection of domestic jobs to be a central economic policy aim. In the US, an additional \$790-billion economic stimulus package was adopted immediately after President Obama took office. The package includes a "Buy American" clause intended to give preferential treatment to domestic suppliers in public procurement, and is leading to countermeasures by other countries. In some cases, there have been tariff increases and trade-distorting currency depreciations. Already the announcement of protectionist measures can have immediate adverse effects on policy decisions elsewhere and one is reminded of the US Smoot-Hawley act of 1930 with its dramatic negative consequences on global trade and economic growth afterwards.

Efforts should be made to strengthen multilateral organizations at this moment in the current global crisis. DIW Berlin advocates the reform of the International Monetary Fund. In addition, the G-20 should play a larger role in combating international financial crises. Finally, in the future, the EU should only be represented in the G-20 by a single representative.

In the US, real GDP declined at an annualized rate of 6.3% in the fourth quarter of 2008.¹ The contraction of the US economy thus accelerated toward the end of last year. At the beginning of 2009, unemployment reached 7.6%—the highest level since 1992. In February 2009 the US economy shed 651,000 jobs again. This was the worst month of job losses since December 1974.² In order to counteract these negative trends, an economic stimulus package of US\$790 billion was passed.³

The package requires government agencies in the US to give preferential treatment to domestic suppliers when awarding contracts with stimulus funds. This would constitute a clear violation of the rules of the World Trade Organization (WTO)

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¹ US Bureau of Economic Analysis: Gross Domestic Product: Fourth Quarter 2008 (Final), press release on 26 March 2009.

² US Bureau of Labor Statistics: The Employment Situation, February 2009, press release on 6 March 2009.

³ H.R.1 Amendment No. 98 in the Senate of the United States—111th Cong. 1st Session. Additional information about the legislative history of this amendment is available at <http://readthestimulus.org/index.php>.

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and NAFTA (North American Free Trade Agreement).⁴ The “Buy American” clause, which requires foreign suppliers to underbid US companies by 25% to be considered for a contract, is equivalent to a protective tariff of the same size. According to an initial assessment by the Peterson Institute for International Economics, implementation of the “Buy American” clause would only create around 9,000 jobs. Between 6,500 and 65,000 jobs would be lost, however, due to protectionist countermeasures taken by other countries. A growing number of countries—including Argentina, Brazil, China, France, the UK, India, Indonesia, Italy, Canada, and Russia—have already taken initial steps toward shielding their national markets.⁵

The danger of the “Buy American” clause is compounded by the interconnectedness of the global economy, as production disruptions could be triggered worldwide. Additional problems could also result for US companies if they are unable to rely on longstanding business relations with foreign partners. Moreover, considerable bureaucratic problems and monitoring expenses in connection with practical implementation of the Buy American clause are likely.

This unilateral action by the US not only heightens the threat of a trade war, it also patently contradicts President Obama’s declared intentions. Stronger international cooperation and the coordination of American economic and foreign policy is a prerequisite for the urgently necessary reform of the global economic and financial order. Doubts about the willingness of the US to make reforms in this area would encourage other countries to embark on their own course.

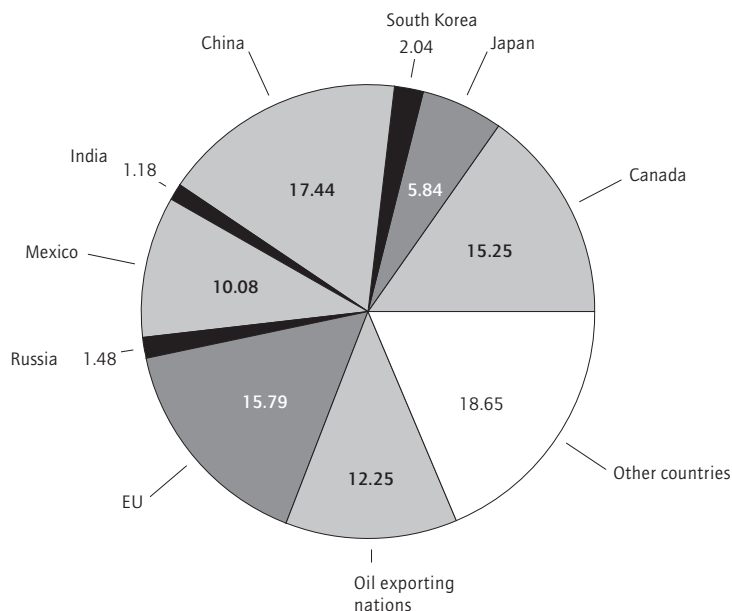
Which US Trading Partners Would Be Particularly Affected?

The US is economically interconnected first and foremost with its two NAFTA trading partners, Canada and Mexico (Fig. 1). Approximately one quarter of all US imports originate from these countries (15% and 10%, respectively). Other important trading partners are China (17.4%), the EU (15.8%), and oil-exporting countries like Saudi Arabia (12.3%). By comparison, countries such as Japan (5.8%), South Korea (2%), Russia

Figure 1

US Imports According to Country of Origin in August 2008

In percent



Source: IMF.

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(1.5%), and India (1.2%) are only of secondary importance where US imports are concerned. With an import share of 4.1%, Germany is the US’s most important European supplier, ahead of the UK, which has a 3% share.

Old and New Forms of Protectionism

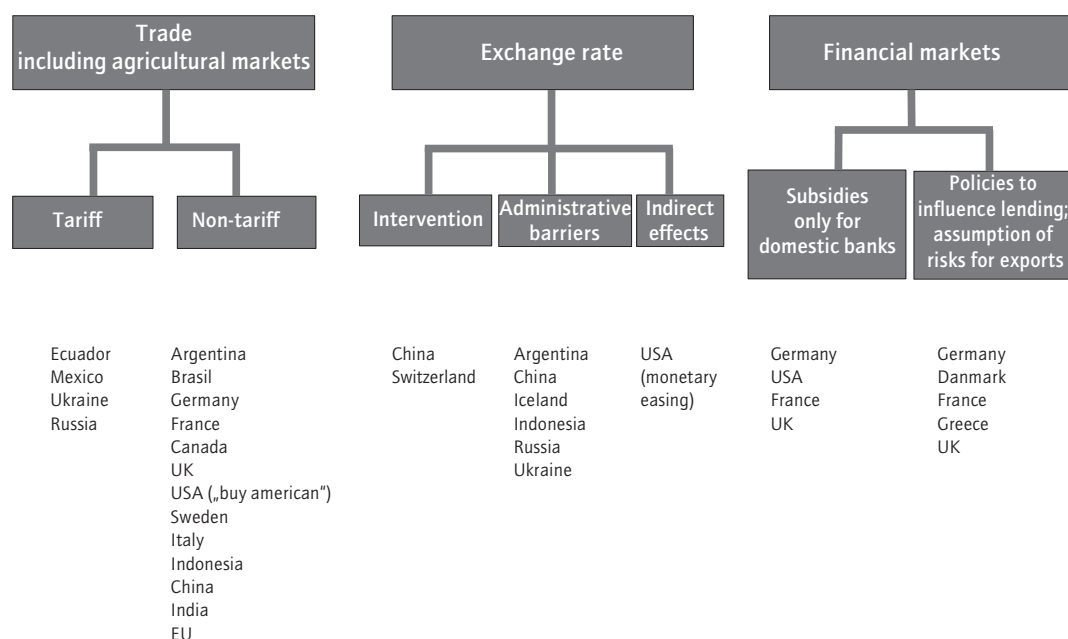
Aside from traditional methods of protectionism such as tariffs, which are now tightly regulated by international agreements, there are more subtle means of erecting barriers to foreign suppliers who want to enter a market (Fig. 2). Influencing exchange rates to achieve a systematic devaluation of one’s own currency and thus a price advantage for exports should also be considered a “non-tariff” barrier to trade.⁶

⁶ China has been criticized by many trading partners, particularly the US, for keeping the value of its currency artificially low. For more information, see the website of the Peterson Institute for International Economics in Washington, D. C., www.iie.com/research/topics/hottopic.cfm?HotTopicID=3, as well as scholarship from J.A. Frieden on the fundamental reform of the global monetary system: Global Governance of Global Monetary Relations: Rationale and Feasibility, in: *Economics (e-Journal)*, Vol. 3, March 2009.

⁴ Hufbauer, G. C., J.J. Schott: *Buy American: Bad for Jobs, Worse for Reputation*, Policy Brief, Number PB09-2, Peterson Institute for International Economics, Washington, D.C.

⁵ The World Bank has compiled a summary of protectionist actions taken worldwide since October 2008. See World Bank: *Trade Notes*, Number 37, 2 March 2009.

Figure 2

Forms of Protectionism in Selected Countries

Source: Compiled by DIW Berlin.

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A new form of protectionism could arise if, in the course of the global financial crisis, restrictive lending policies are practiced in relation to foreign borrowers. The extensive nationalization of banks in numerous OECD countries and the massive government expenditure to recapitalize the banking sector are generating strong political demands for the granting of credit on a preferential or even exclusive basis to domestic companies as well as calls for the alignment of lending to the demands of the domestic economy. This, however, would make it more difficult or impossible for foreign borrowers to access credit markets. In extreme cases, it could even result in balance-of-payments crises between entire nations.⁷

Companies in nations with underdeveloped capital markets and high national budget deficits would be especially hard hit by political intervention in credit markets. The World Bank, for example, anticipates that developing nations will have a finance deficit of \$270 to \$700 billion this year as a result of the global financial crisis.⁸

Moreover, the restructuring of national financial systems is leading in many cases to a concentration of market power among a small number of dominant firms, which makes lending more expensive due to reduced competition. In countries that limit the ability of foreign financial institutions to enter domestic markets, a consolidation of the banking sector results in deadweight losses.

Substantial Deadweight Losses From Protectionism

A 1992 analysis on protectionism focused exclusively on the cost to consumers resulting from a reduced variety of products. The study, which was premised on a decline in international trade of 25%, estimated average global deadweight losses—i.e. in general terms, a decrease in income—of approximately 5%.⁹ These losses are compounded by a drop in efficiency on the production side, especially if returns to scale exist, because firms produce fewer units and thus at higher unit costs when there is a reduction in trade. These losses

⁷ Eichengreen, B.: Capital Flows and Crisis, Cambridge, MA, 2004.

⁸ Theis, D. M.: Crisis Reveals Growing Finance Gaps for Developing Countries, March 2009 press release, World Bank, Washington, D.C.

⁹ Feenstra, R. C.: How Costly is Protectionism? in: Journal of Economic Perspectives, Vol. 6, 1992, 159 ff. The margin of fluctuation in various scenarios based on this average is relatively high at 2–8%.

can be inferred from studies regarding efficiency gains due to trade deregulation with returns to scale (for example, deregulation in North America). The estimates in these studies diverge widely depending on the underlying assumptions, but indicate that deadweight losses would range from 1% to over 8%. A survey of multiple studies yields an average of 3.5%. Adding up both losses—5% on the consumption side and 3.5% on the production side—provides a rough measure of the total cost of protectionism. With a 25% reduction in international trade, social welfare suffers deadweight losses of 8.5%. This means that as long as a 25% reduction in trade persists, national income will be 8.5% lower. The Great Depression provides a historical example of a drop in international trade on this scale. A large percentage of the reduction in national income that was experienced can be attributed to protectionist measures (see Box).¹⁰

Measured in terms of the ratio of exports and imports to GDP, the US and Germany's level of economic openness is around twice as high today as it was before the Great Depression. Financial markets are also much more closely interconnected. Consequently, the impact that protectionist measures would have on national income would become necessarily greater today. Furthermore, in contrast to the Great Depression, governments are more likely in the current crisis to resort to veiled, non-tariff barriers to trade. This is because most nations are members of the WTO and cannot impose tariff hikes at will.¹¹ Yet veiled protectionist measures can have an even greater impact than tariffs. Compliance with new administrative regulations for imports, for example, can prove so difficult to fulfill that they prevent trade completely.

Consideration must also be given to the manner with which protectionism affects individual social groups. Declines in production are associated with job losses, and because these primarily affect less

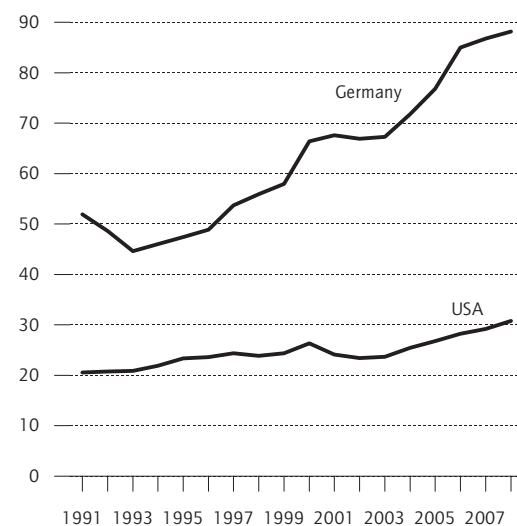
¹⁰ The US also played a central role in intensifying the Great Depression with the passage of the Smoot-Hawley Act in 1930, which drastically increased tariffs. This contributed to a trade war in which nations attempted to shore up domestic industry and employment through isolationism and devaluation but achieved exactly the opposite—global trade was disrupted on a lasting basis and the international division of labor collapsed. See Archibald, R. B., D. H. Feldman: *Investment During the Great Depression: Uncertainty and the Role of the Smoot-Hawley Tariff*, in: *Southern Economic Journal*, Vol. 64, No. 4, 1998, pp. 857-879; and Irwin, D.: *The Smoot-Hawley Tariff: A Quantitative Assessment*, in: *Review of Economics and Statistics*, Vol. 80, No. 2, 1998, pp. 326-334.

¹¹ If a nation raises tariffs anyway, it must reckon with WTO sanctions. This can take a long time, however, and ultimately, if a country fails to comply with a WTO ruling, the WTO can only permit other countries to impose countermeasures against the country in violation. As a last resort, the country that is in violation of the rules can also be excluded from the organization. However, this would only contribute to further protectionism.

Figure 3

US and German Openness¹ in Foreign Trade

In percent



¹ Sum of exports and imports in relation to GDP.

Sources: IMF; calculations by DIW Berlin.

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skilled workers first, groups with comparatively low incomes suffer more from reductions in trade. Low-income groups also consume a comparatively higher share of their income. As a result, production-side efficiency losses and resulting price increases affect such groups more severely.

Proposals for the Improvement of the Institutional Framework for Trade

The Bretton Woods institutions—i.e. the World Bank and International Monetary Fund (IMF)—were created in 1944 in part to prevent a resurgence of protectionist measures in an economic crisis. According to Article VIII of the IMF's statutes, balance-of-payment restrictions are forbidden. The IMF and World Bank provide comprehensive financing facilities so that countries with declining exports do not have trouble financing trade deficits in a moment of crisis. With outside assistance, the country is provided with time to make economic reforms and boost the competitiveness of its exports. Beyond the Bretton Woods institutions, the WTO has its own adjudicative mechanism. The EU member states are also subject to European law. Although extensive, this institutional framework is not sufficient to prevent protectionist measures from

Box

Protectionism and Global Trade during the Great Depression

In the early phase of the Great Depression (1929-1933), real global trade decreased by one third, real production in the USA and Germany dropped by 30%, and the unemployment rate rose to 25% in the US and nearly 30% in Germany. Although drastic tariff increases in the US were not implemented until the passage of the Smoot-Hawley Act in June of 1930—the year after the collapse of the stock market—the Act is viewed as partly responsible for the crash of October 1929 because of the debate that preceded its passage and worries of protectionism, which had a negative impact on stock prices.¹ The mere discussion of protectionism can have immediate effects on markets and has negatively influenced stock prices in the current crisis.

An empirical analysis of the causes of the strong decline in international trade during the Great Depression reveals that approximately half of the decline can be attributed to discretionary protectionist measures and the other half to the general reduction in income. This analysis also accounted for feedback effects.² Protectionism is subdivided into tariff and non-tariff measures as well as effective tariff increases resulting from the deflationary process over time (under nominally fixed tariffs). The “contribu-

tion” made by each of these elements to the decline in trade was estimated at eight percentage points for tariff measures, six percentage points for non-tariff measures, and five percentage points for inflation-induced restraints on trade (for a historical comparison of the levels of openness of national economies, see the chart below).

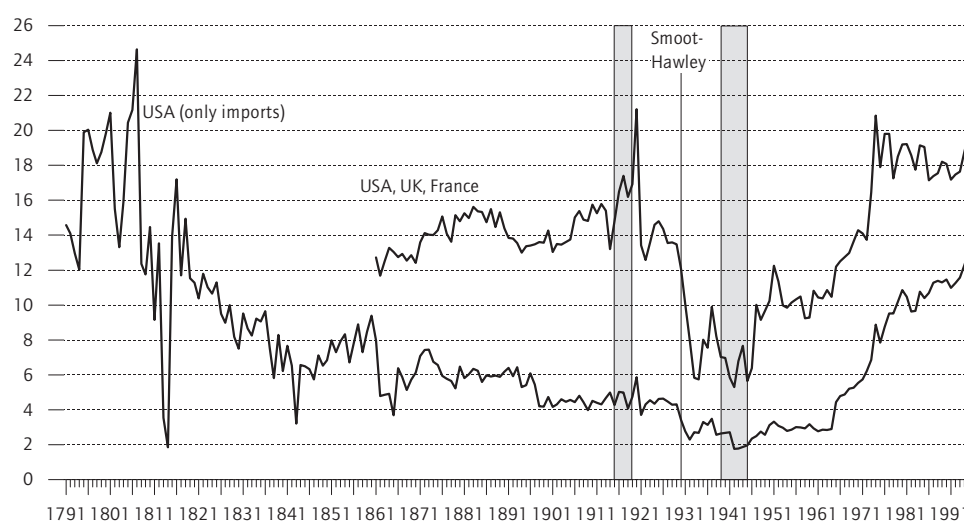
Granted, it is impossible to draw conclusions about the effect of protectionism on income trends directly from these estimates because the connection between the global volume of trade and effective income trends varied from country to country. In the US and Germany, the effective decline in income during the Great Depression nearly equaled the decline in effective international trade, i.e. real income reacted very elastically to changes in the real volume of international trade. Because this assessment places the blame for approximately half of the decline in international trade during the Great Depression squarely on the shoulders of protectionism, the decline in income could have potentially been cut in half if the Smoot-Hawley Act and protectionism on all sides had been prevented.

¹ However, the key cause of the collapse in stock prices was not anxiety about protectionism, but excessive profit expectations based on a technology push (like e.g. electricity, automobiles, chemistry and aerospace industries) and a real estate price bubble.

² Madsen, J.B.: Trade Barriers and the Collapse of World Trade during the Great Depression, in: *Southern Economic Journal*, Vol. 67, No. 4, 2001, pp. 848-868.

Level of Openness¹ of the US and in the US, UK and France

In percent



¹ Sum of exports and imports in relation to GDP.

Source: Chase-Dunn, C., Y. Kawano, B. Brewer: Trade Globalization since 1795: Waves of Integration in the World-system. In: *American Sociological Review*, February 2000, Millennial Symposium.

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being implemented in times of need. For this reason, the regulations and institutions currently in place should be reviewed. In the process, it should be remembered that institutional rules have proven ineffective time and again precisely at the moment when they are most required. Governments simply circumvent, repeal, or change them. This is especially true where large, powerful nations are concerned.

The role of the IMF could be strengthened by improving its legitimacy through a change in the process by which lead officials are selected, so that qualified candidates are considered regardless of nationality.¹² A reduced emphasis on the voting rights of the traditional member nations as well as a reduction in the minimum number of votes for certain decisions would also be necessary in order to weaken US veto power. The IMF's resources could also be expanded. In the current crisis, for example, the US Federal Reserve alone has extended the credit volume by more than \$600 billion. The IMF, by contrast, has only additionally supplied \$50 billion since September of 2008. The IMF's total resources are also limited to \$250 billion. However, although many have argued for increasing the IMF's resources, one objection that could be raised to this proposal is that the IMF has repeatedly made serious mistakes when advising countries in need of aid, in some cases even leading to currency crises.¹³

As a possible alternative or supplement to stocking up the IMF's resources and as an alternative to the ad hoc balance-of-payment loans currently being extended by the USA, EU, and other industrialized nations, the creation of a special subcommittee of the G-20 for quick decision-making on balance-of-payment loans in times of crisis should be considered.¹⁴ The G-20 was created in response to the international monetary and financial crisis of 1998. Its further refinement thus appears to be a logical step. The advantage of a G-20 subcommittee over the IMF as well as ad hoc measures taken by central banks would lie in the direct availability of resources, rapidity, heightened legitimacy, and improved efficiency, as discussion and coordination would take place directly between governments in the G-20 subcommittee. By contrast, lending policies undertaken by the IMF or specific nations are de facto subject to the influence of a small circle of individuals, even though, in the case of the IMF, a formal decision is made by the Board of Governors.¹⁵

The proposed addition of a subcommittee to the G-20 for balance-of-payments loans leads to another consideration. The G-20 has evolved into a very important body for international coordination. The EU is represented in the G-20 by four countries (Italy, France, Germany, and the UK) as well as by the presidents of the EU Council and the European Central Bank (ECB). If the EU created a committee that was responsible for improved coordination of EU economic policy, the four represented EU countries might be more willing to agree on a single joint EU representative. This would not only help to give the G-20 more clout, but would also implicitly compel the EU nations to come to an agreement and stake out a uniform position prior to G-20 meetings.

¹² See Truman, E.: IMF Reform: An Unfinished Agenda, Peterson Institute for International Economics, 28 January 2009, www.petersoninstitute.org/publications/opeds/oped.cfm.

¹³ Stiglitz, J. E.: *Globalization and Its Discontents*, New York, 2002, *The Roaring Nineties*, Washington D.C., 2003; and *Making Globalization Work*, New York, 2006. There is a wealth of literature documenting the theoretical and empirical flaws in the design of the IMF and its policies, see, for instance, Jong-Wha, L., S. Kwanho: IMF Bailouts and Moral Hazard, in: *Journal of International Finance*, Vol. 27, No. 5, 2008, pp. 816-830; Dreher, A., R. Vaubel: The Causes and Consequences of IMF Conditionality, in: *Emerging Markets and Trade*, Vol. 40, No. 3, 2004, pp. 26-54; Evrensel, A.: Effectiveness of IMF-supported Stabilization Programs in Developing Countries, *Journal of International Money and Finance*, Vol. 21, No. 5, 2002, pp. 565-587. Following the Asian and then global financial crisis in 1997/98 the "international financial architecture" was already reformed, among other measures the "Financial Stability Institute" was founded (as an extension of the Bank for International Settlements in Basel) whose members are the banking

supervisory authorities, the finance ministries and central banks of industrialized countries. Together with an enhanced capital markets division of the IMF it was expected that this reform could effectively prevent repetition of worldwide financial crises. In addition there have been repeated warnings in 2006-2007 from renowned scientists of a coming substantial financial crisis in the US, for instance by Professor Nouriel Roubini (Columbia University, New York City) at lectures at IMF premises. The IMF rejected these warnings by arguing that Roubini's analysis lacked a formal mathematical model. See, for instance www.nyt.com/2008/08/17/magazine/17pessimist-t.html and New York Times, June 6, 2006.

¹⁴ Despite the recent agreement among the G-20 countries to increase IMF lending resources, considerable disagreement remains among them about how the world economic system and in particular the IMF should be reformed. In this regard, see the G-20 Finance Ministers' and Central Bank of Governors' communiqué in Horsham, Great Britain of 14 March 2009 as well as the Declaration: Summit on Financial Markets and the World Economy in Washington, D.C., of 15 November 2008.

¹⁵ Because the IMF Board of Governors holds a limited number of meetings each year with more than 170 member nations with periodic reports in addition to numerous special studies and administrative papers, it is virtually impossible for the individual Governors to find, understand, and scrutinize hidden important details about transactions regarding specific sovereign loans in the reports.

Conclusion

The global economic crisis is creating strong political incentives for individual nations to close off their markets in order to protect domestic employment. If a trade war results, this could lead to a massive additional disruption of the global economy. Because trade relations are generally based on specialization advantages, an interruption or lasting obstruction of trade would cost all countries dearly in the end.

In light of this, comprehensive institutional reforms must be made in the organizations responsible for the supervision and regulation of international trade relations and global financial markets: the WTO and IMF. In the process, major developing and emerging nations must be afforded a greater opportunity to participate, as has already been done in the G-20. The G-20 should play a bigger role in combating international financial crises. In order to bring the interests of EU member nations to bear more effectively, a single joint representative should be sent to the G-20 instead of individual representatives from each of the four major EU member nations. This would require a more intensive process of coordination among the EU states. A delegation of strong representatives within the G-20 would also constitute a more effective counterbalance to the perennial domination of the US. On the whole, this could prove to be a much stronger deterrent to unilateral trade policies and the non-adherence of individual nations to legal and regulatory frameworks for free trade.

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