The nuts and bolts come apart

As global demand contracts, trade is slumping and protectionism rising.

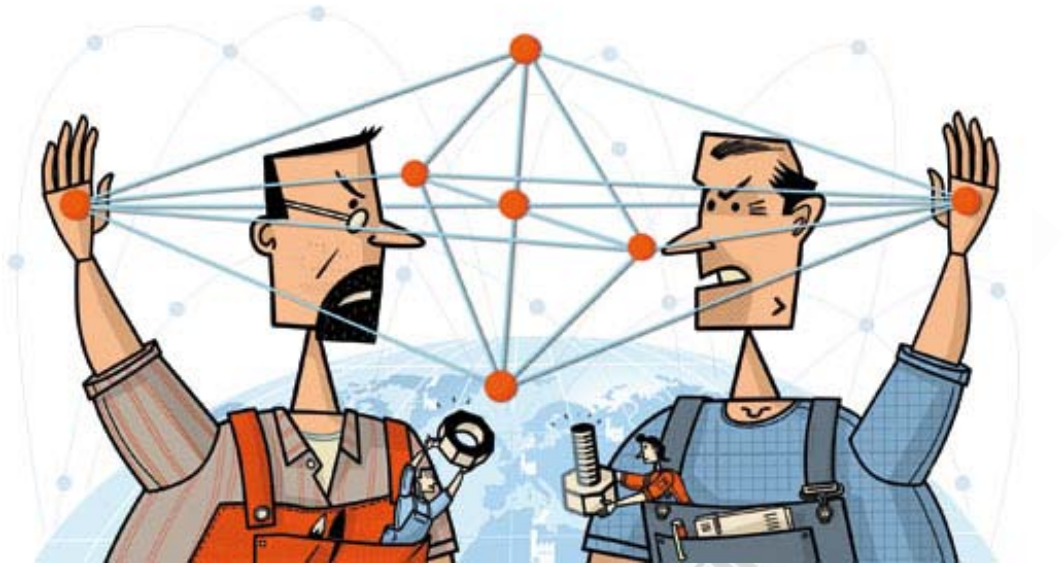

Illustration by Ian Woodcock

Comparisons to the Depression feature in almost every discussion of the global economic crisis. In world trade, such parallels are especially chilling. Trade declined alarmingly in the early 1930s as global demand imploded, prices collapsed and governments embarked on a destructive, protectionist spiral of higher tariffs and retaliation.

Trade is contracting again, at a rate unmatched in the post-war period. This week the World Trade Organisation (WTO) predicted that the volume of global merchandise trade would shrink by 9% this year. This will be the first fall in trade flows since 1982. Between 1990 and 2006 trade volumes grew by more than 6% a year, easily outstripping the growth rate of world output, which was about 3% (see chart 1). Now the global economic machine has gone into reverse: output is declining and trade is tumbling at a faster pace. The turmoil has shaken commerce in goods of all sorts, bought and sold by rich and poor countries alike.

It is too soon to talk of a new protectionist spiral. Nevertheless, errors of policy risk making a bad thing worse—despite politicians' promises to keep markets open. When they met in

November, the leaders of the G20 rich and emerging economies declared that they would eschew protectionism and will doubtless do so again when they meet on April 2nd. But this pledge has not been honoured. According to the World Bank, 17 members of the group have taken a total of 47 trade-restricting steps since November.

Modern protectionism is more subtle and varied than the 1930s version. In the Depression tariffs were the weapon of choice. America's Smoot-Hawley act, passed in 1930, increased nearly 900 American import duties—which were already high by today's standards—and provoked widespread retaliation from America's trading partners. A few tariffs have been raised this time, but tighter licensing requirements, import bans and anti-dumping (imposing extra duties on goods supposedly dumped at below cost by exporters) have also been used. Rich countries have included discriminatory procurement provisions in their fiscal-stimulus bills and offered subsidies to ailing national industries. These days, protectionism comes in 57 varieties.

There are good reasons for thinking that the world has less to fear from protectionism than in the past. International agreements to limit tariffs, built over the post-war decades, are a safeguard against all-out tariff wars. The growth of global supply chains, which have bound national economies together tightly, have made it more difficult for governments to increase tariffs without harming producers in their own countries.

But these defences may not be strong enough. Multilateral agreements provide little insurance against domestic subsidies, fiercer use of anti-dumping or the other forms of creeping protection. Most countries are able to raise tariffs, because their applied rates are below the maximum allowed by their WTO commitments. They may choose to do so despite the possible disruption to global supply chains. And because global sourcing amplifies the effect of tariff rises, even action that is permissible under WTO rules could cause a lot of damage. The subtler variants of protection may be similarly disruptive.

The gears of globalisation

The immediate cause of shrinking trade is plain: global recession means a collapse in demand. The credit crunch adds an additional squeeze, thanks to an estimated shortfall of $100 billion in trade finance, which lubricates 90% of world trade.

Just as striking as the speed of the downturn in trade is its indiscriminate nature. The World Bank has January trade data for 45 countries (available figures for G20 countries are shown in chart 2). These are values, expressed in American dollars, and so have been depressed not only by lower volumes but also by falling prices and a stronger dollar. The exports of 37 of these 45 countries were more than a quarter lower than in January 2008. Countries as diverse as Ecuador, France, Indonesia, the Philippines and South Africa saw exports drop by 30% or more. Commodity exporters, such as Argentina, have suffered with sellers of sophisticated manufactures, such as Germany and Japan.

Kei-Mu Yi, an economist at the Federal Reserve Bank of Philadelphia, argues that trade has fallen so fast and so uniformly around the world largely because of the rise of "vertical specialisation", or global supply chains. This contributed to trade's rapid expansion in recent decades. Now it is adding to the rate of shrinkage. When David Ricardo argued in the early 19th century that comparative advantage was the basis of trade, he conceived of countries specialising in products, like wine or cloth. But Mr Yi points out that countries now specialise not so much in final products as in steps in the process of production.

Trade grows much faster in a world with global sourcing than in a world of trade in finished goods because components and part-finished items have to cross borders several times. The trade figures are also boosted by the practice of measuring the gross value of imports and exports rather than their net value. For example, a tractor made in America would once have been made from American steel and parts; it would have touched the trade data only if it was exported. Now, it may contain steel from India, and be stamped and pressed in Mexico, before being sold abroad. As a result, changes in demand in one country now affect not just the domestic economy but also the trade flows and economies of several countries.

This mechanism can be seen at work in recent data—for instance, says Mr Yi, in American automotive-trade figures for the last three months of 2008. Imports from everywhere fell by about 20%. On the export side, sales to America's partners in the North American Free Trade Agreement (NAFTA) fell by 20% whereas those to non-NAFTA countries rose slightly. This, he argues, is because three-quarters of exports to non-NAFTA countries consist of finished vehicles, whereas 60% of exports to NAFTA partners consist of parts and components, most of

which return to the United States embodied in imported vehicles. So American exports to other NAFTA countries are to a large extent determined by America's own demand for cars.

By making trade flows more sensitive to falls in output, vertical specialisation may provide some insurance against widespread protectionism. Manufacturers that rely on imported inputs may resist higher tariffs because they push up the prices of those inputs, making domestic industry less competitive.

Governments using tariffs as trade weapons now have to calculate the consequences far more carefully. This is borne out, for example, by Mexico's response this month to the suspension by America of a NAFTA programme that allowed some Mexican truckers to carry goods north of the border. Mexico raised some tariffs, but by less than NAFTA rules allowed, and chose the goods carefully in order to limit the damage to its own industries.

Nevertheless, there is plenty of evidence that developing countries, at least, continue to use tariffs extensively. In the World Bank's study, tariff increases accounted for half of the protective measures by these countries. Ecuador raised duties on 600 goods. Russia increased them on used cars. India put them up on some kinds of steel. Developing countries have more scope for raising tariffs without breaking WTO rules than richer ones do, because the gap between their applied rates and the ceilings they agreed to is greater than for developed countries.

When governments do impose tariffs, vertical supply chains amplify their effects. Because tariffs are typically levied on the gross value crossing the border (with some exceptions, such as exports from Mexican maquiladoras), trade responds more to changes in tariffs—down or up—with global supply chains than without.

But there is another, more subtle reason to worry about even small rises in tariffs. Theoretical models that incorporate vertical specialisation find that it takes off only when tariffs fall below a threshold level. Once this happens, however, trade explodes, so that a slight lowering of trade barriers can cause a huge increase in trade. By the same token, if tariffs rose above a certain point—which might be below the maximum agreed on at the WTO—global supply chains would disintegrate. Trade would drop even more steeply than it has in recent months.

That said, supply chains need not snap so easily. Even if tariffs go up, other costs that determine the viability of supply chains may go down: the price of oil (and hence the cost of transport) has fallen a long way in the past year. Firms have invested a lot in their supply chains and will be loth to abandon them. And if global supply chains do survive, vertical specialisation could help trade recover speedily when demand returns.

Although increased tariffs are a cause for concern, they are far from the only form of protection being used in this crisis. Two-thirds of the trade-restricting measures documented by the World Bank are non-tariff barriers of various kinds. As with tariffs, developing countries are the principal wielders of these weapons.

Indonesia has specified that certain categories of goods, such as clothes, shoes and toys, may be imported through only five ports. Argentina has imposed discretionary licensing requirements on car parts, textiles, televisions, toys, shoes and leather goods; licences for all these used to be granted automatically. Some countries have imposed outright import bans, often justified by a tightening of safety rules or by environmental concerns. For example, China has stopped imports of a wide range of European food and drink, including Irish pork, Italian brandy and Spanish dairy products. The Indian government has banned Chinese toys.

In addition, anti-dumping is on the increase. The number of anti-dumping cases initiated at the WTO had been declining, but it started to pick up in the second half of 2007. The data for 2008 are not yet complete but Chad Bown, an economist at Brandeis University, estimates that the number was 31% higher than in the previous year. The number of cases ending with extra duties went up by 20%. India was the biggest initiator of anti-dumping action, and America and the European Union imposed duties most frequently.

Rich countries' weapon of choice so far is neither tariffs nor non-tariff barriers to imports. They have been keen users instead of subsidies to troubled domestic industries, particularly carmakers. Some economists, such as Gene Grossman, of Princeton University, cite this as evidence that global sourcing has changed the political economy of protection. The American automotive industry no longer lobbies for direct protection, as it used to, because it imports much of its value-added and competes with foreign firms that assemble their cars in America. Carmakers now prefer explicit subsidies, and the world is replete with examples. Besides America, Argentina, Australia, Brazil, Britain, Canada, China, France, Germany, Italy and Sweden have all also provided direct or indirect subsidies to carmakers. The World Bank reckons that proposed subsidies for the car industry amount to $48 billion. Nearly 90% of this is in rich countries, where it can easily be slipped into budgetary packages to stimulate demand.

The worry about such subsidies is that they could cause production to switch from more efficient plants (eg, in central and eastern Europe) to less efficient ones in rich countries with deep pockets (eg, in western Europe). Whether the location of output is shifting is not yet clear, but politicians plainly hope it will. On March 19th Luc Chatel, the French industry minister, boasted that Renault's plans to create 400 jobs at a factory near Paris by "repatriating" some production from Slovenia was the result of government aid. Renault has denied this, saying that it was at full capacity in Slovenia.

There are some international rules to prevent distorting subsidies. The EU has regulations to limit state aid, and is looking into its members' assistance to carmakers. Gary Hufbauer, of the Peterson Institute for International Economics in Washington, DC, argues that American subsidies transgress WTO norms.

Helpful ambiguity

However, WTO action against subsidies is not straightforward. To complain successfully, a country has to show that a subsidy meets several criteria. Then there is a pots-and-kettles problem: having subsidies of your own does not stop you from challenging someone else's, but if you pick a fight they may have a go at yours. This uncertainty and ambiguity only adds to subsidies' attraction. Governments can aid their carmakers and at the same time criticise others for their protectionist ways.

Protectionist urges are also being bolstered by countries' seeming inability to co-ordinate their fiscal stimulus programmes. Some countries have been reluctant to work the budgetary pump for fear that their extra demand will leak abroad to the benefit of foreigners. To stop the seepage, some governments have inserted discriminatory conditions into their fiscal programmes, the prime example being the "Buy American" procurement rules. These were weakened after protests and threats of retaliation from abroad, but not before the prospects for global co-operation had been dented. Greater co-ordination of fiscal expansion would ease governments' worries about leakage, because everyone else would be leaking too: all would gain from each other's spending.

Illustration by Ian Woodcock

What should world leaders do to stop protection fraying the threads that tie the world economy together? The pious declaration at the previous G20 meeting has had little effect. There is a risk that another such promise on April 2nd will prove to be just as empty. The difficulty lies in devising something comprehensive and detailed enough to address the variety of protectionist measures that are being deployed in the crisis, and doing it quickly enough to maintain open trade.

Many argue that the most important thing for world leaders to do is to pledge a quick completion of the Doha round of trade talks, which stalled for the umpteenth time last summer. By reducing tariff ceilings, this would place tighter limits on countries' ability to increase tariffs. It would also ban export subsidies in agriculture, which are being used with greater vigour, especially as prices of farm goods fall. The EU, for example, has announced new export subsidies for butter, cheese and milk powder. Most important, completing Doha would be the clearest and most tangible evidence possible of a commitment to consolidating and building on the gains from more open trade secured in successive rounds since the second world war.

Some economists disagree. Aaditya Mattoo, of the World Bank, and Arvind Subramanian, of the Peterson Institute, argue that the Doha round is too ambitious given the state of the world economy, because it seeks to open markets for rich countries' manufactured goods just when the politics are against it. At the same time, they point out that Doha would not restrict the use of some non-tariff measures causing most concern, such as the Buy American provisions or subsidies for failing industries. Messrs Mattoo and Subramanian suggest a new "crisis round" of world trade talks. In the first instance, WTO members could commit themselves to a standstill on all forms of protectionism.

Several other economists have also proposed a standstill. However, Messrs Mattoo and Subramanian suggest that in order to give governments a political reason to agree to this, they should also be allowed to postpone further liberalisation for the duration of the crisis. They would then embark on a new round instead of Doha, which would address the forms of protection that now look most pressing.

But the appetite for starting yet another series of talks is likely to be limited. Even if the crisis round's agenda were more realistic than Doha's (which isn't obvious), there would be no guarantee that it could be concluded quickly enough to stop the bleeding in global trade.

Whatever they think about Doha or about the idea of a crisis round, most economists will agree that a simple promise to resist protectionism will not suffice. Some thing more specific is needed. A good start would be for governments, beginning with the leaders of the G20, to draw up a comprehensive list of protectionist measures that goes beyond tariffs and export subsidies. They could then agree to go no further with these than they have already.

Next, an agreement on co-ordinating fiscal policy would go a long way towards making such a standstill commitment credible, because it would alleviate worries about leakages abroad. Finally, empowering the WTO to name those who break the standstill would help to underpin it. The threat of embarrassment may make some countries think twice.

During the Depression, the volume of world trade shrank by a quarter. Nothing like that has been seen or forecast so far. Yet one lesson from the worldwide economic distress of three-quarters of a century ago is that once trade barriers come up, they take years of negotiation to dismantle. Preventing protectionism from getting worse is preferable to having to repair the damage afterwards. And even if a full-blown trade war can be ruled out, death by a thousand cuts cannot. The costs of myriad piecemeal measures could still add up to damaging protectionism. And when demand does eventually revive, if the world economy is supported by an open system of trade, it will recover all the faster.

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