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Protectionism

The global financial crisis led to an unprecedented collapse in international trade. Since the start of the crisis, the protectionist tide has been rising, although thankfully not as severe as during the Great Depression of the 1930s. What has been the impact of restrictive trade measures so far? Is there a risk of further protectionism? And how should policies respond? A recent article in the IMF's Finance and Development publication looks at these issues in details and provides some answers (see http://www.imf.org/external/pubs/ft/fandd/2010/03/henn.htm).

The great trade collapse that occurred after the failure of Lehman Brothers in September 2008 was unparalleled in its suddenness. In developed as well as emerging economies, export values declined on average by 30 percent in just four months. In terms of composition, trade in goods and transportation services fell the most, while trade in business and other services was relatively more resilient. The overall drop in trade appears out of line with the decline in GDP, which declined by "only" 2.2 percent in the G-3 (the U.S., euro area, and Japan) over the same period. There are three key reasons for this divergence.

First of all, the importance of global supply chains implies that goods are traded several times before reaching the consumer. The much stronger global linkages between firms can also explain why inventory adjustment occurred so suddenly and why the decline in trade was so synchronized and homogeneous. Second, much trade takes place in "non-essential" goods, consumption of which can be postponed during uncertain economic times. For example, trade in motor vehicles declined much more sharply than goods imports more generally. A third reason could be the declining availability of trade finance and overall credit as the crisis originated in the financial sector. However, country experience is more mixed and the evidence less conclusive about the importance of this channel. Although some surveys suggest that trade financing contracted, particularly in developing countries and for small and medium sized enterprises, others conclude that trade financing generally remained available, although at a higher cost.

As the crisis intensified, more countries resorted to measures to restrict trade. Although only a few countries introduced tariff measures, the use of trade remedy measures such as antidumping has increased. Although more difficult to track and quantity, the usage of "back-door" measures to restrict trade, such as product standards, import licensing, or customs procedures, may also have increased. Often as part of stimulus packages, most G20 countries have increasingly used public procurement policies ("Buy National") with trade distorting consequences. Evidence suggests that, for those goods on which the measures were applied, import restrictions or export subsidies significantly distorted trade. However, at the same time, their coverage has been relatively narrow and the impact on total global trade so far has been modest.

Nevertheless, the danger of protectionism and a vicious cycle of retaliation can hardly be overestimated. More open trade policies are associated with higher per capita income levels and growth by raising productivity, stimulating capital flows and labor migration, encouraging technology transfer, and by promoting good governance. Open trade regimes also promote macroeconomic stability by reducing the exchange rate adjustment required in case of external imbalances and by moderating the probability and cost of capital account crises.

Even during the 1930s, countries were aware of the adverse consequences of protectionism, but did not manage to prevent it from undermining the recovery by stifling trade growth for years. There was no World Trade Organization yet to facilitate international cooperation. In addition, during the Great Depression countries may have resorted to trade barriers because they lacked other instruments to try to stimulate their economies. For example, the response of monetary policy was constrained by the gold standard. From that perspective, the large monetary, fiscal, and financial stimulus packages during the recent global financial crisis have not only supported the economy directly, but perhaps also prevented greater political pressure to introduce costly trade measures.

This could change in the period ahead and the threat of rising protectionism still poses a risk to the recovery. Studies show that demand for protectionism increases if the real exchange rate appreciates or unemployment increases. Generally, following a financial crisis, unemployment rates tend to remain at elevated levels (and wage growth suppressed) for a large number of years. This time will likely be no exception, at least for the advanced economies. The combination of recovering imports with stubbornly high unemployment could raise political pressure for trade measures particularly in an environment of still large global imbalances. Much past liberalization in emerging markets also remains vulnerable to reversal as tariff rates in many countries are well below maximum levels allowed under WTO rules. For these economies, particularly those that have relied on export-led growth, political pressure could come from capital inflows leading to exchange rate appreciation, affecting the export sector.

Maintaining supportive macroeconomic policies to keep the recovery on track and stimulate job markets remains essential, particularly for advanced economies. Structural economic reforms to strengthen competitiveness and productivity, and achieve greater product differentiation are much preferred over import substitution for those countries experiencing exchange rate appreciation. Together with regional initiatives such as the Asean Free Trade Agreement, a swift conclusion of the Doha Round is imperative to entrench open markets and economic progress around the world.

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