Chapter 1.

Summary, Conclusions and Recommendations

This chapter summarises the main findings of this report and draws out the main conclusions. While the report finds that protectionist responses to the crisis were relatively muted and protectionism does not explain a major part of the fall in trade that occurred, vigilance is nevertheless needed. Stimulus measures taken behind borders may have very significant effects on trade, especially if they target specific sectors or only domestic goods or firms. Analysis of the stimulus measures generates some insights into exit strategies that could be supportive of growth, employment and trade. It is expected that protectionist sentiment will increase as unemployment remains high and governments are increasingly under fiscal pressure. Concluding the Doha Development Agenda negotiations could prevent backsliding and provide a much needed impetus to growth.

The sharp and synchronised drop in economic activity that began in late 2008 and spread quickly across the globe has had a deleterious impact on international trade. In the first quarter of 2009, the volume of OECD imports and exports was down by about 15% compared to the same quarter in the previous year and GDP by almost 5%. In the second quarter, imports and exports were still sharply down (exports by 15% and imports by 13%) and real GDP by more than 3%. Overall, world trade declined by 12.5% in volume terms in 2009 compared to 2008.The latest OECD forecast is for an increase of 6% in 2010.

Governments have responded to the crisis by introducing deep monetary easing and large fiscal stimulus packages with the objective of supporting economic activity and jobs. Inter-governmental forums, such as the G8 and the G20, are providing the platforms to coordinate the responses, including in the area of international trade where leaders have committed to maintaining markets open as an integral part of getting the world economy out of the crisis; leaders have also committed to providing short-term credit facilities to mitigate against sharp increases in risk premiums. Looking ahead, the immediate challenge for trade policy makers is to ensure that the crisis that has impaired world trade does not spill over to the trade policy agenda.

The disproportionate collapse in trade can be explained by a combination of three main factors: (1) The collapse in domestic demand; (2) the disproportionate fall in outputs and trade of capital goods that make up a larger share of trade than of GDP; (3) the temporary drying up (and subsequently lower availability and higher cost) of short-term trade finance. The drop in demand has significantly contributed to the drop in trade but it cannot explain it fully. Compositional differences between trade and GDP also contributed to the severity of the trade collapse; sectors hit hardest by the crisis (*e.g.* fuels, machinery and transport equipment or manufactured goods) have a relatively higher share in trade than in GDP. Our findings also suggest that

trade finance becomes more important during times of crisis; and this was a contributing factor to the drop in trade. Structural factors related to vertical specialisation and global supply chains explain, as least in part, the highly synchronised nature of the trade collapse

There is no evidence that would suggest that protectionism was a major factor behind the trade collapse. This is the case despite many examples of individual countries taking specific measures to increase tariffs or otherwise increase protection through non-tariff measures or increased resort to trade remedies.

The majority of the new measures affect already highly protected sectors such as agriculture, textiles, and metal industries thus reversing some of the hard won gains that were realised during more than five decades of trade diplomacy. These sectors are also relatively labour intensive, and as such are sectors in which some less developed countries have a comparative advantage. These sectors are clearly in need of more market opening, not further restrictions.

In its July 2009 report, the WTO Secretariat stated that contrary to 2008, "the number of new trade-restricting or distorting measures announced or implemented since 1 March 2009 exceeds the number of new trade-liberalizing or facilitating measures by a factor of more than two." A closer examination of the measures reveals that they have principally been introduced in specific sectors, and very rarely have general applicability. In most cases restrictions also target products from specific sources. According to one estimate, the new trade restricting measures affect less than 1% of the pre-crisis level of imports. Indeed, there have been a significant number of trade opening measures.

Complacency is not justified. While the scale of the measures taken has been relatively modest, the simulations carried out for this study show that among the different types of measures studied, direct trade restricting measures generate the worst outcomes in terms of trade and growth both of the country implementing the measure and of its trading partners. Governments therefore need more than ever, to be vigilant and to avoid protectionist actions that may be politically expedient in the short term but that could have devastating long term consequences. The danger is that restrictions could build up incrementally, slowly stifling trade and ultimately weakening the effectiveness of all the anti-cyclical measures that have been introduced. Protectionist sentiments are likely to increase with persistent unemployment and mounting pressure on government finances. Moreover, once put in place protection becomes entrenched and is increasingly difficult to undo. Retaliation may occur compounding the effects of unilateral measures. Continued attention and vigilance are therefore needed.

Of immediate concern is the impact on trade of behind-the-border measures that are found in the crisis-induced fiscal stimulus packages. We generally think of protectionism in terms of measures at the border – tariffs, quotas or other mechanisms that restrict trade or make imported products more expensive. But there is a wide array of measures that governments can take behind their borders that will have very similar effects – including various forms of direct subsidies. Support to one sector in one country, whatever the motivation, disadvantages competing sectors in other countries. As other countries then move "to level the playing field", a subsidy competition is launched that in the end benefits no country. But those that receive subsidies may be better off than otherwise, and will vigorously defend their

new entitlements; this explains in large part why subsidies to deal with a short term problem often prove almost impossible to remove.

Countries that do not have the fiscal resources to compete on the basis of subsidies will be major losers in this situation, finding themselves excluded from protected markets. There is an enormous danger that the important advances made in recent years by some developing countries whose economies were lifted by aid and by trade, will be lost.

Various domestic regulatory measures that operate behind-the-border can also act as a form of protectionism. Although harder to document, there have also been reports of more restrictive implementation of regulatory measures, both at and behind borders. Stricter implementation of SPS or TBT measures, more complicated border procedures, or other less transparent devices will slow down imports and carry the same threat of corrosive retaliation that could lead to an escalation of trade tensions.

The objective of the measures included in the stimulus packages was to prevent collapse in sectors of systemic importance to the economy – such as banking and finance, to support sectors particularly severely hit by the effect of the drying up of credit, such as automobiles or consumer durables, or to generally support growth and employment – such as consumer tax reductions or labour market measures. These measures did not target trade as such, but they often have significant effects on trade through various indirect channels. The purpose in exploring them here, along with their effects on GDP, is to generate insights into how stimulus measures can be designed to meet their declared objectives while also supporting trade or being as minimally disruptive of trade as possible. These insights in turn are relevant to the design and sequencing of exit strategies, it being again recognised that the timing and manner of the exit strategies to be adopted will be determined by many factors and not mainly by trade-related considerations

Simulations carried out on the impact of some of these behind-the-border measures highlight the critical need to properly target policy interventions. If the intervention is seeking to remedy a shortfall in demand, demand-side measures are a more appropriate response than supply-side measures. But the specific design characteristics of demand-side measures determine their effectiveness in terms of their impact on GDP and on trade. Policies that bias demand towards specific sectors, and those that are biased towards domestic products are inferior to those that are more generic in design.

Sector-specific supply-side measures are found to yield mainly negative effects on the economy taking the measure, through maintaining or creating inefficiencies, and they yield negative spillovers on partner countries, through lowering production costs in one country relative to the world market.

Sector-specific supply-side subsidies can have an anti-export bias. Although they may increase exports of the industry subsidised they draw resources away from other sectors so that total exports may fall. Their positive effect on own GDP is strongest when the subsidy is given to labour rather than to capital (in a situation of unemployment).

General consumption subsidies such as tax reductions or payments to households are relatively trade-friendly. Partner exports can rise following a domestic demand stimulus, and own country exports can rise as well, provided the demand stimulus

does not lead to an appreciation of the real exchange rate. GDP impacts are also generally positive.

Sectoral consumption subsidies may also be trade friendly, at least in the short term, boosting exports and GDP in both the country taking the measure and in partner countries. When countries take similar measures (as in the incentives provided to consumers to purchase cars in many countries) leakages are less of a problem and everyone gains, except where the consumption subsidy is restricted to domestically produced goods. In this case there are negative own-country export effects and negative third-country GDP effects.

All sector specific interventions, by retaining additional resources in the sectors concerned, will have a dampening effect on growth in the longer term. This is why it is critical that support be restricted to activities whose failure may carry systemic risks with a clear timetable for restructuring and eventual withdrawal of support.

The implications for trade of increased government spending depend crucially on the composition of the increased spending. Business as usual — that is, maintaining the composition of existing spending — may contain some anti-trade bias as government expenditures tend to be dominated by non-tradeables. On the other hand, shifting expenditure towards investment in infrastructure, and provided that no "buy national" or other discriminatory provisions are incorporated, may prove supportive of trade.

Almost all measures, if taken unilaterally, have a beggar-thy-neighbour effect — that is, they reduce third-country GDP. Co-ordination offsets the depressing effect in the case of demand push measures but compounds it in the case of sector-specific, supply-side measures. The latter are largely self-defeating when taken by several countries in the same sector. These findings suggest that international coordination could be important as governments move to unwind certain measures.

With respect to supply-side measures, design features are crucial to the outcomes. A subsidy to labour, whether generic or specific to an industry, will generate better outcomes in terms of trade and own GDP effects than a capital subsidy, particularly in a situation of unemployment.

Two main factors have combined to prevent the proliferation of the kind of beggar-thy-neighbour protectionist policies of the 1930s. An increasing number of firms are global; they have organised their sourcing activities across different countries in order to reduce costs and improve their capacity to react to new technologies and changing tastes. These firms need open markets and any intervention that would break links in the global supply chain would undermine their competitiveness.

The second factor relates to the continuous fight against protectionism that the WTO, with its arsenal of internationally binding rules and disciplines, has been waging. Many of the more worrying or less transparent measures that are explicitly protectionist in intent or effect have been in areas where WTO rules are either weak or non-existent. This is perhaps most obvious in the case of the WTO Government Procurement Agreement that does not forbid a signatory country from having measures that impose "buy local" requirements on government spending. Scrutiny of stimulus packages has also focussed attention on the extent to which government procurement in many economies has escaped meaningful discipline in the past.

Closing this gap in the multilateral trading system would offer a further guarantee against the risk of sliding towards greater protectionism.

Another area of concern in the current environment is the temptation to raise tariffs from their applied rates to their legally bound ceilings. While this is a WTO-consistent action, a recent study by Bouet and Laborde (2009) shows that if all countries were to follow on this path, global trade would suffer a loss of USD 809 billion, and global GDP would shrink by 0.65%. One sure way of preventing this loss from actually occurring is to seek in the DDA the reduction or total elimination of the "water in the tariff" that is found in a large number of countries' tariff schedules.

The WTO is entrusted with monitoring trade policy developments in member countries, thus furthering its constructive role in managing the crisis and contributing to the restoration of healthy trade. The OECD is complementing the WTO efforts in this area by examining the impact of the trade-related policy responses to the crisis. This project is but one manifestation of the OECD-WTO co-operation.

What should governments do next?

The most urgent action would be to roll back the most obvious trade-restricting measures that have been taken such as tariff increases and import licensing, and to show restraint in initiating any further trade restricting actions. Taxing production and growth through new trade restrictions will only serve to offset the benefits of the stimulus policies that have been introduced. Mindful of this contradiction, several countries have taken steps to further open their markets. Many more could follow their example.

In order to ensure that the trade recovery is not interrupted by a further series of restrictive measures, it is of the utmost importance that the DDA be brought to an ambitious and balanced conclusion. This would have the benefit of preventing backsliding, bringing much needed stability and predictability to international markets, and would, through further opening, give impetus to the recovery. If, as many commentators suggest, the temptation to resort to protectionist measures will increase as governments begin to unwind the fiscal stimulus measures but unemployment remains persistently high, the "locking in" and market opening effects of a successful DDA conclusion could be crucial.

Consideration also needs to be given at an early date to trade policy issues related to climate change. Pressure in many OECD countries to offset or "countervail" through subsidies or import restrictions the higher production costs that may arise following the anticipated introduction of carbon taxes and other regulatory changes is bound to mount. Multilateral co-operation in this area would serve to reduce trade tension.

During the current crisis most governments have provided support to their financial sector to limit the economic effects of the crisis and reduce systemic risk. These have been necessary steps taken under extraordinary circumstances where information on the nature and distribution of risk was far from perfect. As financial markets return to normal, well designed and internationally coordinated exit strategies will be needed to ensure financial markets are both open and supported by adequate regulation.

On trade finance, careful monitoring will be needed so that governments can begin to step back from the exceptional measures taken in the crisis so that as

markets normalise, the level playing field can be ensured and the creation of subsidies avoided. The key here will be to remove measures once it can be established that there is no longer a need for them: Issues of crowding out are important.

Explicitly discriminating provisions of fiscal stimulus measures should be removed. There is still time to do this in programmes that involve continuing investment over the medium term. Procurement provisions can be made more neutral in infrastructure projects that are still on-going. This would also help to avoid an escalation of retaliatory measures. Where there is suspicion of informal (and non-transparent) pressure to discriminate in favour of national or local suppliers, governments should disavow such suspicions. More generally, scrutiny of stimulus packages has revealed the extent to which government procurement in many economies has escaped meaningful discipline in the past. It has also revealed how difficult it is to monitor or discipline buy local or national provisions at different levels of government. Public procurement needs to be brought forward as a priority issue for multilateral discussion in the post-crisis period.

Timing and sequencing of actions to dismantle stimulus measures will be important. A return to a more disciplined fiscal stance is imperative, but governments also need to be sure that the incipient recovery is not stifled. These considerations will determine the appropriate exit strategy. With respect to trade-related aspects, withdrawal of sectoral stimulus measures may prove to be particularly problematic. Demand has been stimulated in the automobile industry to the extent that consumers have brought forward purchases. There is therefore a danger of an imminent period of slack demand and therefore slack trade in this important "trade intensive" sector. Previously existing problems in these industries might re-surface.

Amid signs that recovery is underway, governments are now beginning to reflect on how best to return to pre-crisis levels of intervention and spending. The way in which governments exit from the extraordinary measures taken in the past year and the pace of that exit will have impacts on employment, growth, real interest rates and exchange rates. Trade flows will be affected directly and indirectly. Particular attention will need to be paid to sectoral measures. They create rents and vested interests and are very difficult to dismantle. But the longer measures are left in place, the greater the damage in terms of efficiency and competitiveness (and therefore trade) of the economy as a whole. On the other hand, governments do not want to take steps that could delay recovery by exiting prematurely.

It is important that trade and investment continue to flow freely reflecting comparative advantage and responding to economic opportunity. Globalisation and increasing market openness did not cause the crisis that emerged in mid-2008, but certainly contributed to the speed and scale of the contagion. The perception that globalisation was somehow the cause may persist and mean that there is less appetite for rolling back protectionist measures taken in the context of the crisis, or for concluding the Doha Development Agenda. This must be resisted. There are many countries that have not yet joined the club of emerging economies whose rapid growth is due to a large extent to the way they have engaged in international specialization through open trade and investment regimes. The important long term goal should remain focused on the preservation and strengthening of the international trading system. This will allow these countries to catch up, even if growth in trade is slowing elsewhere.

Box 1.1. Business as usual or a "new normal"

There is a newly quoted phrase in international financial circles that speaks of an eventual return to a "new normal" where growth will be subdued and unemployment will remain high. What is the likelihood of a return to the previously observed growth rates in trade?

Macro-economic factors

The US federal budget deficit is estimated to have reached more than 11% of GDP in 2009, and to remain around that level in 2010. Other OECD countries have also introduced fiscal stimulus packages that eventually need to be scaled back. The short-run effect of the stimulus is higher demand, including more import demand and a widening current account balance in the countries where stimulus packages are introduced. Thus, some of the stimulus "leaks" to trading partners. An interesting question is then whether the scenario will be reversed as the stimulus packages unwind; i.e. narrowing current account deficits and less trade.

The answer depends on the nature and speed of the exit strategy. It is clear that governments can run fiscal deficits for long periods of time without increasing the debt burden as long as the nominal rate of GDP growth is higher than the interest rate of government debt. Therefore, adjustments can be done gradually as private sector growth picks up. In the current situation, the fiscal stimulus packages may be scaled back relatively soon, both because of their scale and because government debt is already high in many OECD countries. In this scenario a narrowing of the current account balance and less trade could result.

Rebalancing could also go in the opposite direction. The countries that have been running perennial trade surpluses could in principle increase their imports. But that assumes that consumers in surplus countries would have to expand spending. To give an example, China's final consumption expenditure accounted for only 51% of its GDP in 2008 as compared to 75% on average in middle income countries. If China were to increase the share of final consumption in GDP towards the average for middle income countries, say to around 60% in the first instance, consumption would increase by about USD 355 billion (based on 2008 figures). If this increased demand were entirely satisfied by imports, trade would obviously increase by USD 355 billion.

The policy shifts required to raise domestic consumption would be multifaceted. First, the need for households to save would have to be reduced through better social insurance coverage. Second, access to credit for financing consumer durables or other expensive items would be needed. An adjustment of the exchange rate can also help narrowing global imbalances. There are, however, dangers related to a sharp appreciation of the currency of surplus countries, *e.g.* the Chinese remninbi. First, as experience from Japan in the 1970s and 1980s shows, a sharp appreciation need not significantly narrow the current account surplus by itself. Instead, if the intended structural shifts in domestic demand failed to materialise, growth could slow down. Furthermore, the structural changes needed may be easier to engineer within a fixed exchange rate regime, as it is well known that fiscal policies do not have much of an impact in a floating currency regime.

In the longer term, real interest rates are expected to rise as governments lean on capital markets to finance continuing high deficits. Higher interest rates tend to reduce the demand for durable consumption goods and investment goods, while demand for non-durables tends to increase – this will have commensurate effects on trade patterns.

Micro-economic factors

Will trade growth continue to be driven by vertical fragmentation? The extent of international fragmentation observed at its peak cannot be sustained in a downturn, but what about in its aftermath? The marginal return to further fragmentation may diminish for at least two reasons. First, fragmentation requires more co-ordination, and rising co-ordination costs will sooner or later offset the lower cost of outsourced parts, components and tasks, first at the firm level and later at the macro level as well. Second, the leaner and more effective the supply chain the more vulnerable it becomes to delays in delivery of parts can components, and the risk of delays increases with distance to the market (Harrigan and Venables, 2006).

Another long-term trend that could affect future developments in world trade is the growing share of services in GDP and consumption. Services are less traded than goods, which should by itself moderate growth in trade relative to GDP growth. Furthermore, even within the services sector, demographic factors may shift demand from tradable transport, ICT, financial and travel services to less tradable health care and other personal services.

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