



# Trade and the Global Economic Crisis

## Immediate Challenges and Long-term Threats

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### Summary points

- The collapse of world trade is threatening to create a negative feedback loop to the global economy. Some countries have seen their trade fall by 30–50% in the year to February 2009, a bigger fall than between 1929 and 1930. Annual figures for world trade in 2008 show a big fall in the fourth quarter – a trend that has been accelerating.
- The world's trade ministers have failed to get the Doha Development Agenda back on track, despite direct instructions from the G20 leaders to do so quickly after the November summit in Washington, DC. This failure sends a very powerful negative signal about the G20's lack of policy coordination on even bigger issues.
- There is a two-way interaction between trade and the macro-economy at a national and global level. The current crisis is threatening countries that rely on export-led growth, a strategy that has led billions out of poverty.
- It is imperative for there to be recognition that the current shrinkage in global trade is a macro-economic problem requiring macro-economic solutions, and that the necessary actions must be coordinated.

## Introduction

World trade threatens to implode in the short term as the current global financial crisis unfolds and the credit crunch turns into a contraction in real demand worldwide. The governments of G20 countries must act to prevent increased protectionism making a very bad situation catastrophic. In the longer term the depth of the crisis threatens the model of export-led growth that has led billions out poverty since 1950.

In this paper, we explore what needs to be done – and some of it by no later than the G20 summit in London on 2 April 2009 – to tackle these linked problems and minimize the costs of getting out of the hole the world economy has fallen into in the short and long term.

## What is happening to trade and why it is important

Since the G20 Summit in Washington, DC in November 2008 the situation has been getting worse by the day. The fall in world trade that was noted in the third quarter of 2008 has accelerated. Annual figures for world trade in 2008 show a sharp rise until mid-summer and then a big fall in the fourth quarter. The picture is thus messy but:

- The World Bank on 9 December 2008 forecast a 2.1% fall in world trade in 2009, after an overall 6.2% rise in 2008.<sup>1</sup>
- Also in December 2008, the International Monetary Fund updated its World Economic Outlook (WEO) forecasts and suggested that world trade and production shrank by 42% and 15%, annualized respectively in the three months to November 2008. (By contrast, Kindleberger estimated that between 1929 and 1930 the fall in world trade was 19%.<sup>2</sup>)
- Data for December 2008 suggested an accelerating decline in world trade, with monthly drops in exports reported by China (-2.8%), the US (-6%) and the UK (-3.7%) by value.
- Korean exports suffered a 12% fall in the 4th quarter on 4th quarter.
- Japan reported a 44% fall in exports year-on-year in January 2009 following a fall of 35% in December 2008.
- China reported a 17.5% fall in exports by value year-on-year and a 42% fall in imports in January 2009 (export prices reportedly increased by 2.3% while import prices fell by 10.6%). Data for February were even worse than expected, with exports falling by a further 25.7%.<sup>3</sup>
- In January 2009 World Trade Organization Director-General Pascal Lamy reported to the WTO membership that even though year-on-year 2008 trade was up on 2007, there had been a worldwide decline in November.<sup>4</sup>
- Brazil had hoped to be spared the worst, given the lower export share of its output compared with that of many emerging economies.<sup>5</sup> But by February monthly exports had fallen by a quarter to \$9.6bn, against \$12.8bn a year before, though clearly much of this was due to falling commodity prices. Brazilian industrial production has been dramatically affected, falling by around 12% in December.<sup>6</sup> Some analysts attributed this to a fall in domestic investment.<sup>7</sup>
- Meanwhile 4th-quarter German GDP contracted at an annual rate of over 9% and Japanese GDP by more than 11%, reflecting the impact of lower exports on output.

1 <http://web.worldbank.org/external/default/main?contentMDK=20665751&menuPK=3023135&theSitePK=612501&pagePK=2904583&piPK=2904598>.

2 Charles P. Kindleberger, *The World in Depression, 1929–1939* (London, 1973; revised edition, Berkeley, CA, 1986), Chapter 8, Figure 10.

3 *Shanghai Daily*, 11 March 2009.

4 *Report to the TPRB from the Director-General on the Financial and Economic Crisis and Trade-Related Developments*, 23 January 2009, <http://www.tradeobservatory.org/library.cfm?categoryID=428>.

5 Bloomberg, 2 March 2009, [http://www.bloomberg.com/apps/news?pid=20601086&sid=aVcyiuBL\\_xGQ&refer=news](http://www.bloomberg.com/apps/news?pid=20601086&sid=aVcyiuBL_xGQ&refer=news).

6 'Output sank by 12.4% month-on-month in December', <http://uk.reuters.com/article/marketsNewsUS/idUKN0349650920090203?pageNumber=1>. See also [http://www.ibge.gov.br/home/presidencia/noticias/noticia\\_visualiza.php?id\\_noticia=1310&id\\_pagina=1](http://www.ibge.gov.br/home/presidencia/noticias/noticia_visualiza.php?id_noticia=1310&id_pagina=1).

7 *Financial Times*, 11 March 2009.

- In mid-March the World Bank released a briefing that predicted that 2009 would see the biggest drop in world trade in 80 years.<sup>8</sup>
- On 23 March Pascal Lamy predicted a 9% fall in world trade *volumes* in 2009<sup>9</sup> while on 25 March it was reported<sup>10</sup> that Japanese exports in February were down 50% by value (with a 55% fall in exports to the EU).

These falls are most likely driven by the decline in demand in OECD countries in particular, and by the drying up of trade credit as financial markets have seized up.

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The fall in trade is important for two reasons.<sup>11</sup> First, trade is a bellwether of the wider economy and hence of the crisis. Second, trade fluctuations first follow and then amplify fluctuations in output and demand; the more so if countries respond to the crisis with beggar-thy-neighbour trade policies. This trade policy-driven amplification of the fall in output is what Kindleberger<sup>12</sup> identified as a key feature of the Great Depression and is the fear shared by many economists.

## The political context

### Failure to complete Doha Development Agenda (DDA)

The second important news since the G20 summit in November has been the abject failure of the world's trade ministers to get the DDA process back on track – despite direct instructions from the G20 leaders in Washington to meet in Geneva in December 2008 and

get it done. The sticking point seems to have been the same issues as in July 2008 when the talks failed, namely special safeguards for agriculture demanded by India and China but resisted by the US in particular. At the same time, the US, in an apparent attempt to use the opportunity presented by the crisis, made even greater demands to emerging-market economies for market access in manufactures than those embedded in the texts brought forward from July.

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A success in Geneva in December 2008 would not have changed much directly or soon. Any quick impact on trade requires coordinated macro-economic policy responses to increase global demand. But the symbolism of an agreement in the WTO – which is, after all, the pre-eminent organization for global economic governance – cannot be underestimated. Moreover, the symbolism of continued failure is little short of catastrophic. If the nations of the world, in the face of the greatest peacetime economic crisis since 1929, and with world trade falling off a cliff, cannot complete an unambitious negotiation already seven years in the making, what chance is there to

8 *The Guardian*, 10 March 2009.

9 [http://www.wto.org/english/news\\_e/pres09\\_e/pr554\\_e.htm](http://www.wto.org/english/news_e/pres09_e/pr554_e.htm).

10 [http://www.google.com/hostednews/ap/article/ALeqM5gN\\_kUngERLcfGYFHR3q1grHfn\\_kAD9750NS80](http://www.google.com/hostednews/ap/article/ALeqM5gN_kUngERLcfGYFHR3q1grHfn_kAD9750NS80).

11 These falls are in value terms and partly reflect falling dollar prices, including those for oil, but this is itself a harbinger of worse to come.

12 Kindleberger (1986).

agree the radical changes to global economic policy, governance and regulation required to repair the damage already initiated by the crisis and help guard against similar situations in future?

#### The key players

Fear certainly stalks the chancelleries of Asia. The leaders of Japan, Korea and China all issued strong warnings against protectionism in the run-up to the preparatory meeting of G20 finance ministers in the UK in March 2009. Korea called for the G20 to make a renewed commitment to standing still on new protectionist measures. But India's government faces a general election in May, and trade policy is an electorally sensitive issue to the point where the WTO, and the DDA specifically, is demonized, particularly among rural voters. It has raised steel tariffs.<sup>13</sup>

The European Commission and the EU member states talk the anti-protectionist talk but introduce new antidumping and countervailing duty measures on US biodiesel – in principle both legal under the WTO but nonetheless sending a very bad signal. The big member states are turning to subsidies – notably in the financial sector but also in the automobile industry – and threaten foreign direct investment protectionism against other member states. Overall the Single Market and the state aids disciplines have been shown to be weak in the face of member states' actions.

The major political event in the last three months has been the arrival of a new and eagerly anticipated administration in the US. That alone might have helped unblock negotiations in the WTO. Expectations about the future course of US trade policy were, however, far from euphoric in the rest of the world. The electoral rhetoric both of the Democrats standing for Congress and of President Barack Obama was at best cool towards free trade.<sup>14</sup>

The administration's *Trade Policy Agenda*, published on 27 February, is hard to trace on the White House and

even the US Trade Representative websites, almost as if it is being kept hidden.<sup>15</sup> It is couched in essentially defensive language, shows no strong acknowledgment that free trade is a key to beating the credit crunch and seems mainly to point to the concerns of the unions and the environmental lobbies that have dominated Democratic Party politics on trade for the last decade. This reflects the realities of domestic politics, where recent surveys suggest that a plurality of US voters think free trade is bad for America. Nonetheless the arrival of the new President is a game changer and it is disappointing in the context of the global crisis that Barack Obama is not willing or able to change this stance.

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The new US Trade Representative, Ron Kirk, has no track record in trade policy. His résumé describes a man steeped in domestic and regional politics – albeit in a state (Texas) that is highly dependent on exports. Nor does he appear to have the background of a congressional wheeler-dealer who could steer a liberal presidential trade agenda in response to the global crisis through a legislature that is both responsible for, and currently quite protectionist on, trade policy.

Trade policy is traditionally domestic interest group politics by other means, which underlines its sensitivity. Nonetheless trade is a key indicator of where an economy is efficient and where it is not. This is even

<sup>13</sup> See note 4 above.

<sup>14</sup> See Jagdish Bhagwati for a particularly pessimistic take on Obama and trade: *Financial Times*, 8 January 2009.

<sup>15</sup> But see [http://www.ustr.gov/assets/Document\\_Library/Reports\\_Publications/2009/2009\\_Trade\\_Policy\\_Agenda/asset\\_upload\\_file810\\_15401.pdf](http://www.ustr.gov/assets/Document_Library/Reports_Publications/2009/2009_Trade_Policy_Agenda/asset_upload_file810_15401.pdf).

more important in a crisis than in good times when a rising tide floats all boats.

Against that background, the US and other G20 countries should not move further away from liberal trade policy at this crucial time. Indeed, for the good of their national economies, and for the good of the world economy, and as part of a global response to the crisis that is necessary to encourage others to cooperate with US policies, they need to sustain a liberal trade order.

The United States in particular needs a more liberal trade policy than the one President Obama inherited. This requires political courage, not least in the face of the 'Buy American' rhetoric from Congress, but the President has no apparent lack of that. In his inaugural address he quoted George Washington in response to the current crisis. Benjamin Franklin's famous aphorism at the time of the Declaration of Independence is equally appropriate: 'We must all hang together, or assuredly we shall all hang separately.'

### The threat the credit crunch presents to export-led growth as a development strategy

There is a tendency for the policy implications of trade to be treated at the national and micro level. But there is a two-way interaction between trade and the macro-economy at a national and global level. It is easy to forget that all imports are someone else's exports, and that all surpluses and deficits must add up to zero. This has short-term and long-term implications.

The strategy of export-led growth pulled first Western Europe and then Japan out of the devastation of war in the 25 years after 1950. It then fuelled the rise of the newly industrializing countries of East and Southeast Asia, culminating in the rise of China. Even the so-called 'Hindu model' of economic development has succumbed with spectacular effect in India. Latin America abandoned its long affair with import substitution. Export-led growth has been an enormously successful strategy, generating unprecedented rates of economic growth and pulling billions out of sometimes abject poverty.

And yet one element in this strategy has systematically contributed to global economic instability and crises.

Arguably, the current account crises of the late 1960s, driven by rapid growth of exports and undervalued exchange rates in Western Europe and by lax US fiscal policy, contributed to the break-up of the Bretton Woods system. The Japanese trade surplus and the related undervaluation of the yen in the 1980s nearly led to a trade war with the US and to the Plaza and Louvre currency accords. More recently, the extraordinary accumulation of reserves by East Asian countries has been a major cause of instability and crisis, alongside fiscal and monetary laxity and light-touch regulation of the financial sector in the US and other Anglo-Saxon economies (not least that of the UK). Even Germany undertook a real devaluation in the Eurozone and used export expansion as the key engine to getting out of a low-growth trap in the early years of the new century, effectively pushing adjustment pressures onto the deficit countries in Europe and beyond.

Despite these earlier episodes, the trade imbalances associated with rapid growth in economies emerging onto the world market have been sustainable over the medium term. We fear, however, that the long-run sustainability of this model is now in question. For the world as a whole exports must grow at the same pace as imports. In fact export-led growth has been mirrored by capital-import-led growth in other regions which have been able to grow fast with continuing current account deficits. The most spectacular examples are the US and the UK, but it has also occurred in some developing countries.

Until very recently, the world has assumed that if imbalances at the national level are allowed to continue, then the financial markets intermediating the finance to bridge the shortfalls in deficit countries must have good reason to suppose the debts will be repaid. Recent events in financial markets suggest there is no such guarantee, as in fact was the case in the Latin American crisis of the early 1980s.

The irritable exchanges between US and Chinese policy-makers in March 2009 about who is responsible for the current crisis testify to the sensitivities of the subject. Many observers had long been expecting a crisis of some sort owing to the huge scale of financial flows between China and the US. Brad Setser has remarked that what occurred was not what had been expected, but that

the roots of the current crisis still can be traced to the current account imbalances leading to excess credit in the US – though it was the bubble in the demand for US housing that burst first, rather than the implicit bubble in the market for US government securities.<sup>16</sup>

It is not enough, however, for the creditor nations to say it is all the fault of the debtors (i.e. those countries with persistent current account deficits). All that does is create policy pressures on the back of the implacable truth that debtors in the end must adjust while creditors can sit on their growing piles of cash with equanimity, not to say complacency. Despite this truth, if the adjustment burden takes the form of a reduction in import demand by debtors, with no corresponding rise in the demand for debtor-country exports, there will be a larger than necessary collapse in domestic demand in the debtor nations (as they run out of tax revenue and/or credibility in financial markets). This is likely to be accompanied by an increase in protectionism among the debtors. Any contraction in demand in deficit countries will inevitably lead to a collapse in supply in the creditor countries unless they increase domestic demand by some combination of domestic fiscal stimulus and exchange rate appreciation, and in addition maintain lending to debtors until imbalances unwind.

Unfortunately there is no sign of a consensus emerging between debtors and creditors on burden-sharing in the current global crisis. This is not a new problem. John Maynard Keynes spotted it in the 1930s and regarded it as a key issue in the design of the Bretton Woods system of fixed but adjustable exchange rates. Kindleberger, after him, noted that a global system of adjustment requires either a hegemon or a legitimate system of rules. The Bretton Woods system represented the latter, imposed by the former. At present we have neither hegemon nor legitimate rules. The Bretton Woods institutions have not been allowed by those that control them to adapt quickly to shifts in global economic power and, equally, the G7/G8 is a backward-looking organization with insufficient internal coherence to deliver results. Unfortunately,

as the fiasco at the trade negotiations in Geneva in December 2008 demonstrated, the G20 has the potential to be a talking shop, with no teeth in the face of domestic political imperatives.

The danger from failure to implement such a system is a fall in current global demand, output and trade and the emergence of a low-growth and low-trade global equilibrium. This could signal the end of the export-led growth paradigm that has led billions out of poverty.

The danger to countries seeking export-led growth comes from several sources.

### 1. Slow growth of demand

In the OECD area the credit crisis has already cut the ability and willingness of firms and households to spend, even before second-order effects. The very rapid negative spillovers to countries in the south that had no financial crisis of their own have discredited the idea that there could be a decoupling of growth in the developing world from that in the north. The rise in 'vertical integration' makes the linkage process much stronger.

### 2. Protectionism

Recent evidence suggests a slight rise in antidumping actions in the second half of 2008, but the big falls in trade have happened even before any huge increases in protectionism.<sup>17</sup> As demand falls in the north for internal reasons, there will be pressure to ensure that any demand boosts are seen to focus on domestic output. In the 1930s Keynes advocated protection, in effect arguing that the multiplier effect of boosting domestic demand is greater with less leakage. But what is true for one country is not true for the world. If the eventual unsustainability of large current account deficits leads to demand cuts in debtor countries, there will be pressure for these to fall disproportionately on imports. The effects of protectionist measures are complex, however. The US proposals to buy American steel will not only hit the steel industry in the rest of the world, but above all will create pressures for imitation. The European

<sup>16</sup> <http://blogs.cfr.org/setser/2008/12/01/bretton-woods-2-and-the-current-crisis-any-link/>.

<sup>17</sup> Chad Bown, 'Protectionism is on the rise: antidumping import investigations up to 31% in 2008', in Richard Baldwin and Simon J. Evenett (eds), *The Collapse of Global Trade, Murky Protectionism, and the Crisis: Recommendations for the G20*, <http://www.voxeu.org/index.php?q=node/3199>.

support for national car manufacturers is equally problematic. (But we may ask whether a targeted and distorted stimulus is better than no stimulus.)

Signals are as yet mixed. Pascal Lamy reports that India, Mercosur countries and Indonesia all raised tariffs during 2008. A key insight into the threat to trade is that many measures to restrict trade could be implemented without breaking the WTO rules, e.g. by introducing more antidumping measures or raising applied tariffs to bound levels.<sup>18</sup> Helpfully, Chinese officials have declared they will not back a 'Buy Chinese' policy or other forms of protectionism.<sup>19</sup>

### 3. 'Prudential' macro policies and exchange rate changes

But even if there were no protectionism in the traditional sense, any rebalancing of their current accounts by debtor countries as a result of cutting demand would necessarily impact on the demand for the rest of the world, adding to the tendency for world trade growth rates to fall and, as in the 1930s, even shrink significantly. There is clearly a trade-off between long term and short term here. The big deficit countries, notably the UK and the US, must in the medium term move closer to balance, but should only do so when compensating demand has picked up in the rest of the world.

In the medium term exchange rate changes will clearly be needed, but there is a very fine line between necessary adjustments and beggar-thy-neighbour policies. Appreciations of the euro and the yuan have to go hand in hand with internal demand growth in the Eurozone and China.

### 4. Further feedback from trade to credit markets

What has been happening to trade will set off a further round of repercussions in financial markets. Even without protectionist measures there will eventually be aggregate demand reductions emanating from current debtors who have to adjust, especially if surplus countries become less

willing to make short-term finance available. Credit markets will react. Developing countries are particularly vulnerable to the withdrawal of credit by private banks. The recent rise in the dollar was widely attributed to a 'flight to quality' but may also have been driven by the repatriation of dollars to settle domestic debts. Even though on this occasion the contagion did not start in emerging markets, it seems likely that they will be perceived as more vulnerable in future. International banks had recently begun to explore making loans to strong developing countries in their own currency. These moves are likely to be curbed, putting the exchange risk burden of taking on debt onto the developing world. Pascal Lamy's report noted: 'All in all, a shortage of liquidity and disproportionate aversion to risk led to regular shortfalls in available trade finance supplied by the private sector – according to private sector sources – of about US \$25 billion in November – and the cost of trade credit tripled in some emerging economies, with scarcity of supply gaining ground in the developing world.'<sup>20</sup> Eventually, long-term deficits will have to be financed by long-term funds. Financing current account deficits by FDI puts the risk on to multinational firms, but these flows too are affected as lending to the corporate sector and global demand both dry up, with a consequent threat to the development model in some emerging markets.

If credit markets become more cautious we shall have to adapt to a world in which sustainable current account imbalances are smaller. It has long been noted that there has been less of a global capital market than is sometimes thought.<sup>21</sup> Countries do in fact finance most of their investment from domestic savings. Jagdish Bhagwati has argued that this is just as well.<sup>22</sup> Totally free financial markets would raise worldwide efficiency if the markets were wholly efficient, but we have seen that they are not. We will have to find a new international financial architecture that ensures that funds are available for countries with short-term adjustment finance needs and where real profitable

18 R. Baldwin and S. Evenett, Introduction, *What World Leaders Should Do to Halt the Spread of Protectionism*, <http://www.voxeu.org/reports/protectionism.pdf>.

19 'China: protectionism is no cure to crisis', [http://www.chinadaily.com.cn/china/2009-02/10/content\\_7458688.htm](http://www.chinadaily.com.cn/china/2009-02/10/content_7458688.htm).20

20 See note 4 above.

21 In 1980, Feldstein and Horioka found a much closer correlation between national savings and investment than had been anticipated. See Martin Feldstein, 'Domestic Saving and International Capital Movements in the Long Run and the Short Run', NBER Working Papers 0947, 1980.

22 Jagdish N. Bhagwati, 'The Capital Myth: The Difference between Trade in Widgets and Dollars', *Foreign Affairs*, May/June 1998.

investment opportunities genuinely exceed domestic savings capacity, while at the same time ensuring that lenders only provide funds when they can be confident of sustainability rather than when they just hope that they can be the first to get their money out in a crisis.

## Conclusions

It is imperative for there to be recognition that the current shrinkage in global trade is a macro-economic problem requiring macro-economic solutions, and that the necessary actions must be coordinated.

Protectionism is a threat to recovery in the short to medium term and to export-led growth in the longer term. In our view, this requires an effective moratorium on protectionist measures among the G20 countries that applies to both WTO-consistent and WTO-inconsistent measures. The WTO should be tasked with monitoring the G20 moratorium.

The global imbalances that have contributed to the current crisis also require macro-economic responses, and notably effective and legitimate processes for coordinating policy. The G20 process already engages the key players but in the medium term the representation on the IMF Board in particular must better reflect the realities of the new global economic and financial order.

In the longer term the world needs a set of rules on global coordination of macro-economic policy that smooths the adjustment of the global economy to the emergence of new trading powers and spreads the burden of adjustment among creditors and debtors. The lesson of the 1930s is that, without such rules, nations will become more inward-looking economically and resort to beggar-thy-neighbour economic policies. It took more than a decade and a world war for the Bretton Woods system to emerge from the wreckage of the Great Depression. The emergence of a new system now will also take time, but in our judgment the future of export-led growth as a development strategy depends on it.

Failure will be measured in terms of the lost ability of future billions to emerge onto the world market and grow their way out of abject poverty. Failure now will pull up the ladder on the poorest for decades and possibly generations.

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