Opening Markets as Engine for Much-needed Growth: Imperative for Japan & the EU

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Where Are We on the Protectionist Front?

Since the start of the Great Crisis in the US and Europe in mid-2008, the use of protectionist measures has been well contained. The initial fears of a big protectionist wave (the "Buy US" public procurement policy, the lavish US and EU subsidies to their car producers) gave way to a more complex picture. Most of the countries that did take protectionist measures also adopted measures opening their economies, while some countries (Mexico, Canada, Australia) accelerated their trade liberalization program. Only a few countries (Argentina being the largest) drifted to protectionism, but with little impact on the world trade regime because they were never credible supporters of trade liberalization.

As a result, all in all, the last three years have witnessed a continuous decline of the tariffs among the G20 economies, magnified by an unexpected notable decline in antidumping and safeguard actions. *Chart 1* illustrates the continuous decline in G20 tariffs. It gives an additional key lesson: even before 2008, the long-term declining trend of tariffs has been accompanied by short ups and downs - a feature that suggests restraint when crying wolf about protection.

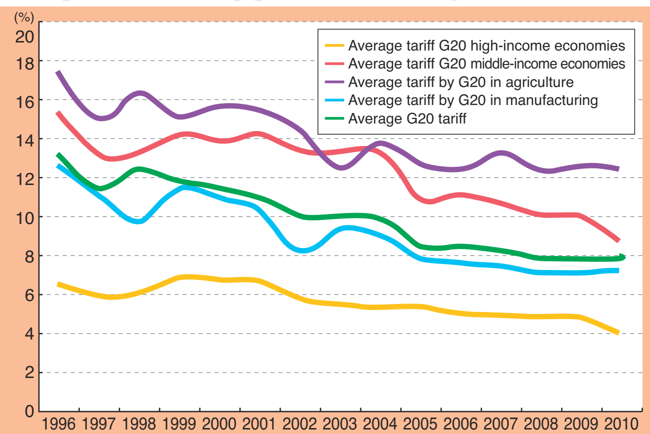
That said, this broad picture deserve three important caveats. First, cutting some tariffs while increasing others increases the effective protection granted to certain existing sectors, with the risk of reinforcing their political clout and triggering domino effects.

Second, an accurate view on the non-tariff barriers (subsidies, tax deductions, norms and non-materialized threats to take action by some officials) and, more importantly, on the true effects of these barriers is not yet available.

Last but not least, banking remains heavily subsidized, particularly in the US and the EU. The 2008 rescues of individual banks have been followed by expansionary macro-economic policies until 2010 that have been generally equivalent to subsidies to banks. Since 2010, key countries and regions (such as the EU) minimize as much as possible the "hair cuts" that their banks should pay for after having made foolhardy operations.

CHART 1

Average G20 tariffs, 1996-2010, simple MFN applied average



Sources: Datt, Hoekman and Mallouche, 2011. WITS data (TRAINS + WTO-IDB), OECD; tariff data missing for Russia '98-'00, Saudi Arabia '96-'98, '10, Indonesia '97, India '10.

Why is the Worldwide Trade System so Resilient?

How to explain such resilience? After all, by the 1929 Crisis standard, the year 2012 would be equivalent to 1933, a year devastated by the impact of widespread protection all over the world. Four main mutually reinforcing factors have played a role:

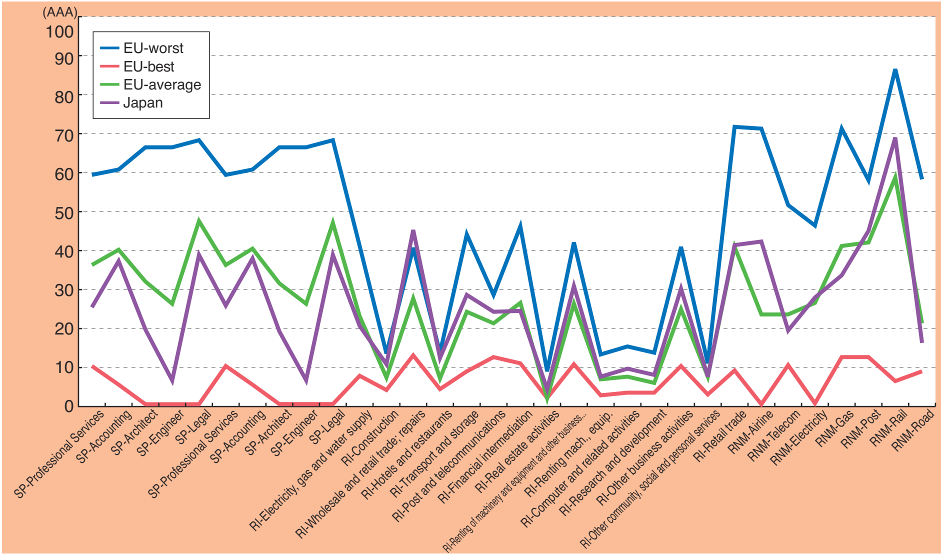
- the modern way of producing goods - international supply chains - makes demand for protection suicidal; during the pre-2008 years, firms were induced to ever expand their supply chains all over the world for two reasons: the perception that transport costs would continue to decline, and the reluctance to consider that wages in the emerging economies should sooner or later become more in line with labor productivity in these countries;
- China's economic success increased dramatically the esteem for trade liberalization and for the WTO-based trade regime: two-thirds of the tariff cuts enforced between the mid-1980s and mid-2000s were unilateral decisions taken by developing countries, and one-fourth the result of the WTO process (the rest being the paltry outcome of the preferential trade agreements);
- US and EU public budgets still offered some room for maneuvers, and the will of the authorities to be the lender of last resort for firms in a difficult situation relied much more on economy-wide expansionary macro-economic policies than on industrial policies targeting certain sectors or firms;
- last but not least, until mid-2010, mother Earth was "quiet" with no natural disasters (tsunami, massive floods, volcanoes, etc.) threatening the supply-chain logistics.

Most of these conditions are challenged today: the long-term trend in transport costs is less easy to predict, wages in the emerging economies are slowly but surely getting more in line with labor productivity, liberalization looks more subject to ups and downs, confidence in the WTO is hurt by a "Sleeping Doha," US and EU public deficits have reached their limits, and the May 2010 eruption of an Icelandic volcano opened a "horribilis" year of natural disasters severely disrupting supply chains logistics in East Asia and North Atlantic.

However, all these challenges have a bright side. Higher transport costs reveal the scarcity of natural resources; wages and productivities more in line are what economic development is all about; liberalization should never be seen as irreversible (never forget that the economic analysis that shows the economic benefits of trade liberalization also shows that there will always be vested interests pushing for protection); a more agitated Earth is the sign that investment is needed in domains

CHART 2

Comparison of regulatory quality, Japan & EU member states



Source: Messerlin (2012 forthcoming), based on the OECD indicators of product market regulations, OECD 2011

considered wrongly as granted - from water supply to climate issues to land management in earthquake-sensitive regions - opening a host of future activities and opportunities, the so-called Green Growth agenda.

Worries should rather focus on two other evolutions rarely noticed despite their very toxic effects. First is the poor quality of the anti-Crisis policies in the US and in the EU. The US and EU Member States' governments have severely cut their public expenditures, with an almost certain recessionist impact in the EU for a couple of years at least. But, they have showed no signs of launching pro-growth domestic reform agendas. Indeed, until recently, they were playing with the strange idea of asking the (much) poorer rest of the world to solve their problems… The comparison with the 1998 Asian Crisis is striking. For instance, in mid-1999, less than two years after the 1997 IMF bail-out, Korea had adopted and started to implement all the needed structural reforms (banking, corporate, labor, competition, etc.).

Second, there is an ongoing "creeping de-globalization." The sector in which this movement is the most visible is banking, with droves of US and EU banks having left the Asian markets. This de-globalization did not occur during the Asian Crisis. On the contrary, US and EU firms entered the Asian markets, largely thanks to the structural reforms undertaken by the Asian countries. When retreating from foreign markets back to their home turfs, many US and EU firms are becoming more national, hence more attracted by the use of protection. From a consumer's perspective, the rapid and relatively widespread attrition of competition gives to the consumers (unaware of the ongoing creeping de-globalization) the impression that globalization does not provide benefits.

What Could be Done: Focus on Japan & EU

In his recent Report on Governance for Growth, the British Prime Minister D. Cameron makes a strong case that what is needed for fighting a possible rise of protectionism is to reinforce the WTO's surveillance role, in particular of the bilateral preferential trade agreements, to refine the WTO Dispute Settlement Mechanism, and to induce the WTO to institute more regular and incremental updates of existing trade rules. These recommendations address well the concerns associated with the above-mentioned four challenges. But, they do not address the much more toxic absence of pro-growth domestic agendas and of creeping de-globalization.

More is thus needed. It consists of fresh re-liberalization initiatives. What follows develops a few points with a focus on a Japan-EU trade agreement.

First, a "Sleeping Doha" means that, like it or not, the only instrument left for opening or re-opening markets to foreign competition are bilateral preferential trade agreements (PTAs). But, a PTA could have a notable impact on a country only if it involves a partner large enough compared to the country in question and one that is willing to open its markets. For the EU, that leaves only the US, Japan and Taiwan. The fact that the US ultimate decision-maker in trade issues - Congress - is divided and unpredictable leaves more hope for a rapid conclusion of a Japan-EU PTA.

Second, PTAs should be designed in such a way that they contribute to the much-needed domestic pro-growth reform agenda. If not, PTAs will not attract the attention of the EU top policy-makers (heads of state and government, key ministers) and they will be doomed to be captured by narrow vested interests, hence to deliver limited (if any) results.

This condition means that PTAs should address regulatory issues - market regulations in services (services which represent 70% of the GDP) as well as norms and standards in goods. The high tariffs remaining on some goods (cars, for instance) would be easier to resolve if included in a bigger package including services.

It happens that the prospects of mutual benefits for Japan and the EU in regulatory matters look very promising. As illustrated by *Chart 2*, the available regulatory indicators in services (100 being given to closed markets) for Japan, the best EU Member State and the worst EU Member State show Japan almost always between the two EU extremes. Such a balanced situation means that, if the EU would benefit from improved regulations in Japan, Japan would benefit from improved regulations in the EUMS - a point often misunderstood or ignored in the EU.

Negotiating on regulatory issues is notoriously difficult. It requires an innovative approach based on mutual evaluation of the regulations existing in the parties, on full mutual recognition when domestic regulations in a given service are considered equivalent by the parties, and on negative lists of services when the regulations are considered non-equivalent (with scheduled reviews of these negative lists). All this is no simple matter, and it requires improved negotiating machinery.

But the stakes are huge for Japan and the EU. Both economies face almost the same problems (though with different time horizons) and need to be seriously revitalized. The cost of inertia would be huge for both countries. For the EU, if it misses this opportunity, its role in East Asia will be minimal forever, because the rapidly coming rise of India will rapidly make the EU look small, hence not so attractive. JS

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