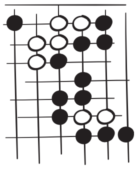

Fighting the Urge For Protectionism

by Fredrik Erixon and Razeen Sally

CRITICS OF "MARKET fundamentalism" and "neoliberal globalization" proclaim the end of a 30-year "free-market revolution." The global financial crisis of 2008, they say, is the last gasp of unbridled capitalism. Politics will once again take primacy over the market. They hail the election of Barack Obama as the dawn of a new Age of Government and global market reregulation, in the U.S. and around the world.

Undoubtedly, the global financial crisis has changed the intellectual climate decisively against free markets and in favor of government regulation. New financial-market regulations are brewing in OECD countries as well as in emerging markets. They concern everything from a global college of financial regulators and stricter capitalization requirements to limits on executive pay, directions to lend to small enterprises and bans on short-selling. Unless current regulatory ambitions are scaled down, they run the risk of stifling market signals and emasculating the entire global economy.

But how far will global financial-market reregulation spill over into wider regulatory intervention in markets for goods, services, workers and capital? Specifically, will it lead to a new Age of Protectionism?

Financial services are first in the line of fire. Tighter prudential controls are one thing, but they should be distinguished from market access and the rules that underpin it. There remains a strong case for removing protective barriers around inefficient domestic incumbents—often state-owned and invariably state-promoted banks and insurers—and exposing them to competition. But emerging-market governments now have the pretext to maintain a *cordon sanitaire* against new entrants.

Worse than stalled liberalization is the danger that previous financial-market opening will be reversed by domestic regulatory sleights-of-hand, such as more onerous capitalization requirements and licensing procedures for foreign services providers. Watch out for such measures in China and elsewhere. And if trade-and-in-

Messrs. Erixon and Sally are directors of the European Centre for International Political Economy.

vestment protectionism gathers pace in financial services, the chances are that it will creep further into other politically sensitive services sectors such as telecommunications, retail and distribution, transport and professional services.

Other emerging protectionist threats were also becoming more potent in the twilight of the Goldilocks global economy—the years of roaring economic growth before a gathering credit crunch turned into a full-blown financial crisis. The latter will likely reinforce and accelerate these trends. Chief among them are:

- *The built-in protectionist backlash against the historic global integration of China and India*. This is aimed overwhelmingly at China. On a grander scale, it replaces the protectionism directed against Japan and other east-Asian Tigers in the 1970s and '80s. In the U.S. and EU, its symptoms are allegations of "unfair trade" linked to "currency manipulation," bilateral trade deficits, hidden subsidies, and low labor and environmental standards. Some of these accusations, especially on deficits and exchange rates, are economic non-issues: they combine analytical illiteracy with a dearth of supporting evidence. But they are live political issues. President-elect Obama made repeated statements along these lines on the campaign trail.

Also note that the "fear of China" and concomitant protectionism is not exclusively a rich-country phenomenon; it also features in other developing countries feeling threatened by the Chinese export juggernaut. That has played into developing countries' defensiveness in the WTO's Doha Round, particularly in the industrial-goods negotiations.

- *Investment nationalism, often combined with energy nationalism*. The United Nations Conference on Trade and Development has recorded an increase in the number of new laws unfavorable to foreign direct investment. In 2007, 24 out of 98 new FDI laws were considered to be less favorable to FDI. That is in line with a trend since 2005: A quarter of all new FDI laws are considered unfavorable to FDI, compared with an average of 7.5% from 1992 to 2004. These restrictions are bunched in energy-related sectors, but they are spreading to other sectors. The Chinese government recently tightened foreign-investment restrictions through a series of regulations and "guiding opinions." These are intended to protect national champions in a range of industrial, energy and services sectors.
- *The climate-change agenda, a Trojan horse of "standards protectionism" in the 21st century*. The EU has an emission-trading scheme in operation. The U.S. Congress will probably pass a similar cap-and-trade scheme next year. Because such schemes impose substantial compliance costs on energy-intensive sectors at home, there will be more pressure to impose similar costs on cheaper, carbon-intensive production elsewhere not subject to carbon-reduction policies. Hence the threat of trade sanctions on "free riders"—China in particular.
- *The backlash against migrants from poor countries*. Immigration reform is stalled in the U.S. Congress. The EU is about to introduce a new "Blue Card" system for high-skilled migrants; and there are calls for extra barriers against low-skilled workers from outside the EU, who are allegedly stealing jobs from the unemployed in Europe.
- *Increasing export restrictions*. Escalating food and other commodity prices in 2007/8 were met by a barrage of export tariffs, quotas and outright bans across the developing world. That was a harbinger, pre-global financial crisis, of other protectionist responses to worsening economic conditions.

Thus protectionist dangers are mounting. But an Age of Protectionism is not inevitable. There are powerful countervailing forces, notably the deep linkages of 21st-century globalization. There is still room for policy choice. All the more reason to make a strong, evidence-based case for open markets, including open markets in financial services, and highlight the costs of protectionist retreat. Here historical lessons of response to crises are in order.

In the 1930s, the Smoot-Hawley tariff and tit-for-tat protectionism followed hard on the heels of the Wall Street Crash. This helped to turn recession into a decade-long depression. Not surprisingly, world leaders have sounded alarm bells against a repeat of the 1930s. But they are fighting the wrong enemy. Current events suggest a different, but still vexing, scenario: the creeping protectionism of the 1970s, rather than the spiraling protectionism of the 1930s.

The threat comes not from the spiraling protectionism of the 1930s, but the creeping variety of the 1970s.

In the 1970s, oil-price hikes and other shocks triggered inward-looking, mercantilist policies, not least in Europe and the United States. Immediate policy responses were not massively protectionist: there was no equivalent of the Smoot-Hawley tariff. But escalating domestic interventions exacerbated economic stress and prolonged stagnation. Not least, they spawned protectionist pressures. Industry after industry, coddled by government subsidies at home, sought protection from foreign competition. The result was the "new protectionism" of the 1970s and 1980s.

Then, as now, manufacturers of gas-guzzling cars in America faced bankruptcy. The U.S. Congress bailed out Chrysler in 1979. By then the British government had already bailed out Rolls Royce and British Leyland, and Renault was saved by French taxpayers shortly after President Carter signed the Chrysler bailout. Several other sectors (wood and timber, energy and minerals, railways, airlines, shipbuilding) received government subsidies in the 1970s. Many companies were nationalized.

Policies like "voluntary export restraints," "orderly marketing arrangements" and other mostly nontariff barriers were deployed to "manage trade." The sectors that received subsidies at home also got protected from foreign competition. Through the 1980s, American car manufacturers were protected by VERs that restricted the number of Japanese cars exported to the U.S. Europe negotiated a similar agreement with Japan in 1983. To further restrict Japanese exports, some European governments imposed "local-content requirements" on the cars produced in Europe by companies like Nissan and Toyota. Many other sectors, like semiconductors and videocassette recorders, were also protected by VERs or similar measures. The French government even demanded that Japanese VCR imports enter France via Poitiers, a town hundreds of miles from the nearest port.

What can be done to prevent a repeat? Many would look to the World Trade Organization as the first port of call. After all, GATT rounds—especially the Uruguay Round—were launched and concluded in response to global economic malaise. Hence G20 leaders, meeting in Washington, D.C. in November, called for the speedy conclusion of the Doha Round. But there are serious flaws to this logic.

First, the parlous state of the WTO—its "U.N.-ization" and the long-running farce of the Doha Round—makes it singularly ill-equipped to respond to systemic threats. Earlier in 2008, global commodity inflation was supposed to concentrate minds and unblock agricultural negotiations in Geneva. It did not happen. Chances are that the global economic crisis will skirt round the WTO, without so much as a passing glance.

Second, even a "successful" Doha Round would be a woefully inadequate antidote to the current crisis; it would hardly begin to tackle emerging protectionist threats. That is because it has been reduced to a pitifully low common denominator. What is on the table would barely liberalize trade, barely strengthen multilateral trade rules, and introduce lots of new "flexibilities"—code for extra bureaucratic complexity and exemptions from common disciplines.

Third, if the WTO is to contain protectionism, it will have to do so in a substantial, medium-term post-Doha agenda rather than through the quick fix of an insubstantial Doha Round. The latter should be concluded swiftly or else scuppered. The main thing is to move on rapidly to serious business. A post-Doha agenda should focus on strengthening multilateral rules for bread-and-butter international commerce, rather than pursue the will-o-the-wisp of liberalization in big trade rounds.

Rules and liberalization are related, but they are not one and the same thing. A rules agenda should close loopholes and tighten disciplines in existing agreements, e.g. on tariff bindings, subsidies, trade remedies and regional trade agreements. It should extend to the "Singapore issues": trade facilitation (already in the Doha Round), investment, competition and government procurement. And it should stretch to newer, pressing issues where WTO disciplines are very weak or non-existent, especially export restrictions, energy, border-security measures and, not least, protectionist threats from climate-change initiatives.

Finally, making progress in a post-Doha WTO will not be possible with the whole membership involved. That is a recipe for continued blockage, and the marginalization and irrelevance that come with it. Getting business done will take "coalitions of the willing" among the one-third of WTO members that account for about 90% of international trade and investment.

The WTO is not the only trade-policy track for containing protectionism. As important will be the revival of unilateral liberalization, outside trade negotiations. This has been the main engine of trade and FDI liberalization across the developing world, especially in dynamic East Asia. China set the pace from the early 1990s, with others following through competitive emulation. But unilateral liberalization has stalled, not least in East and South Asia. Setting it on its legs again, especially to tackle "behind-the-border" regulatory barriers to trade and FDI, will be a powerful counter to emerging protectionism. This should start in China and other parts of East Asia. Overall, bottom-up unilateral reforms are likely to be more effective than top-down liberalization attempts through the WTO, preferential trade agreements and regional economic-integration initiatives.

Also important will be the key bilateral relationships in the world economy. Three stand out: U.S.-EU, U.S.-China and EU-China. Trade tensions between the U.S. and China are hotting up again. Both sides need to contain mutual protectionism and deepen "constructive engagement." Similar tensions exist in EU-China relations. All the more reason to establish a workable equivalent of the U.S.-China Strategic Economic Dialogue (as envisaged in the clumsily-named EU-China High Level Trade and Economic Dialogue-Mechanism).

Containing protectionism, and indeed extending open markets, will facilitate recovery and lay the foundations for future prosperity. Fundamental policy choices lie before us, and the stakes could not be higher. Asian policy makers may not be able to lead the response to global crisis, but they can play a vital supporting role in containing protectionism. Or they can go with the flow of protectionist backsliding—and suffer the consequences.