

## **ARE THERE SPECIAL RISKS FROM TRADE AND FINANCE IN THE 2008-9 RECESSION?**

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December 2008

### **Policy Brief<sup>1</sup>**

All international economic crises have seen an increase in barriers to trade, and such barriers themselves can contribute to crises. A group of economists has published a pamphlet,<sup>2</sup> warning that the risks of protection are now very high and suggesting possible ways of reducing them. When the authors presented their fears and their proposals at a meeting in London, other economists and officials agreed that there are dangers, but questioned whether the authors had identified the most severe risks and challenges and were sceptical about some of their proposed solutions. As financial disruption has been an unusually prominent part of the current crisis, understanding what has been happening in trade-related lending is particularly important. This Policy Brief summarizes the content of the discussions at that meeting.

#### **What are the trade challenges?**

**Challenge:** Historically, governments in the 1930s and 1970s are blamed for not taking sufficient or sufficiently prompt national fiscal and monetary action to raise national demand and output, and instead using trade measures.

**Comments:** In 2008, almost all developed country governments have responded rapidly with monetary measures; most have introduced fiscal stimuli. In contrast to the Asian crisis of the 1990s, these countries are not constrained by the IMF. There can be questions of whether the measures are large enough or correctly targeted, and concerns about countries like Germany which may be more hesitant, but it is harder than in the past to argue that trade measures will be used instead of deflation.

**Challenge:** Published the week before the Doha trade negotiations were suspended in December, the book said that reaching a successful conclusion on them was vital.

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<sup>1</sup> This preparation of this Policy Brief has received the financial support of the Spanish Secretariat for Trade and ACCIÓ (Generalitat de Catalunya). The usual disclaimer applies.

<sup>2</sup> Richard Baldwin, Simon Evenett, ed., *What world leaders must do to halt the spread of protectionism*, VoxEU, 2008, [www.voxeu.org](http://www.voxeu.org). In English, protectionism should refer to attitudes, while taking action against trade is 'protection', so the book and the discussion should be about 'protection'. Protectionism, like superstition, is harmless except where it affects the real world.

Success was a test of the credibility of multilateral commitments: reaching agreement on the ‘modalities’ for a Doha settlement was the only specific agreement at the G20 summit in Washington in November.

Comments: The G20 was not a credible forum for making trade policy, and many people regarded the target of reaching agreement on a complicated set of trade issues within four weeks as rhetoric, not realism. The Doha negotiations were in trouble long before the crisis.

**Challenge:** Without Doha, many developing countries which are applying tariffs well below those ‘bound’ under previous WTO agreements can raise them, damaging world trade. ‘Tariffs facing the exports of rich and middle-income nations would double; those facing poor nations would triple’ (p. 31). Developed countries have similar flexibility to increase their subsidies to agriculture.

Comments: The authors estimate that tariffs facing exports by high and middle income countries could rise from 4.6% to about 9%, and those for low-income countries could rise from 4% to 11.7% (Baldwin, p. 32), i.e. rises of about 4.5 or 7.5 points. They could be damaging for some countries, notably in South Asia as India, Pakistan, and Bangladesh are the only large developing countries with substantial flexibility to raise tariffs, but such rises are not outside normal experience. Price or exchange rate changes can have effects of this size; so can being excluded from other countries’ trade agreements. On agriculture, the rise in subsidies could remove all the reduction in distorting subsidies brought about by the temporary rises in food prices. However, many participants expressed doubts about the correctness of these estimates.

**Challenge:** Trade is falling more rapidly than we realise. China’s imports in November were down 18% compared to 2007. Data on shipping and ports show large falls.

Comments: The falls are real, and normal trade data probably are too slow so we should be alert. But are the falls driving the recession or are they the result of national falls in demand? As one official said, ‘trade policy did not get us into this mess and so it won’t get us out of it’.

**Challenge:** Baldwin argued that the falls in trade are mainly in manufactures and within those in specific sectors. Manufacturers now trade in specialised components of products, rather than in finished products, so general stimulatory responses will be less effective. Countries like China and Vietnam will face the need to promote exports directly, for example through devaluation, in order to avoid social disruption. The US will face similar sectoral problems and therefore retaliate, leading to a spiral of protection.

Comments: The falls are not confined to specialised manufactures. There are indications that tourism is falling by up to 20% in some locations. Remittances by migrant workers are down. Commodity prices have fallen. This means that the risks to economies and social stability may be even greater, but may mean that reflation can help. In both the US and developing countries, there are massive needs and proposals

for spending on reducing carbon emissions. It is hard to know how quickly production can be switched to this.

**Challenge:** In previous recessions, the ways in which governments have increased protection have sometimes been new and unexpected: the tariff rises of the 1930s or the invention of new non-tariff barriers in the 1970s.<sup>3</sup>

Comments: This may be the most difficult protection risk to deal with as new measures will be designed not to be notifiable under any existing agreements and may not be immediately tracked by officials or researchers.<sup>4</sup>

**Challenge:** While regional trade arrangements may protect their members from new barriers within the region, they can still raise barriers to the rest of the world.

Comments: Any increase in tariffs will certainly increase the distortions caused by regional FTAs, but increases in protection may be slower and smaller than those that would have been seen if the countries had not been in an FTA or CU: regional institutions have more complicated requirements for changing policy than most countries.

**Challenge:** It is important not to forget that existing threats to trade from national policies will continue, for example the impact of security regulations on the costs of trading.

### **Are there trade policies which can reduce the risks of protection?**

The authors have proposed five priorities for policy. One, finishing the Doha Round, has already failed.

**Proposal:** WTO members should complete the negotiations on the Trade Facilitation agreement as this is almost ready and an agreement will help confidence.

Comments: Not all experts agree that it would be easy to complete this very detailed agreement. Some countries would oppose any agreement on just one area in the fear that this would remove negotiating points they might want to use later. Some economists oppose 'early harvest' agreements because they remove the pressure to deal with the issues which are more controversial, but also more important.

**Proposal:** The WTO should require all countries to report (perhaps even weekly) all increases in protection, both to provide transparency for exporters and future negotiators and to deter new measures by holding countries to shame.

Comments: Many measures will be new types, impossible to define in such a requirement. Exporters will be the first to know, they do not need a WTO list. When governments face national pressure to take action to reduce unemployment and to

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<sup>3</sup> The share of world trade in manufactures subject to NTBs rose from 13% to 21% in the four years after 1974 (for EU imports from 0.1% to 14%), as so-called voluntary export restraints proliferated.

<sup>4</sup> There is a proposal for a trade modelling group (GTAP) to collect information. Simon Evenett, one of the authors, has compiled a list of proposals and speculation.

counter falls in income, they will not be ashamed to report their policies (they might even welcome the publicity).

**Proposal:** Countries should agree, in the WTO or in regional or other groups, on a standstill on new measures.

Comments: This also raises the problem of definition. To the extent that the measures are definable, it would be more straightforward for each country to make such a pledge unilaterally, but on condition that no other country acted against it. This is not a good time to try to reach international agreements.

**Proposal:** In the absence of a WTO Round, countries should use other institutions to negotiate partial agreements. Services like air or sea transport, for example, have industry arrangements.

Comments: These may offer opportunities and are probably a more promising solution than world-wide commitments, but they have the well-known risks of excluding some countries or types of activity, and building up distortions to deal with in the future.

### **Are there special risks in trade finance?**

The first major events of this crisis were breakdowns in financial flows and collapses of some financial institutions. And any crisis is likely to lead to restrictions in credit. The uncertainties increase actual and perceived risks and markets switch from under-pricing risk when liquidity is abundant to over-pricing it when it is scarce. Some observers have argued that in this recession credit problems have had a particularly serious impact on trade because of a breakdown in trade credits. This is not covered in detail in the book, but formed an important part of the discussion at the meeting.

Trade always creates a need for credit, as a good or service is produced, then shipped or supplied, and finally paid for. The text book model assumes that the actual trading stage, the period of transit from exporter to importer, is financed by a letter of credit, and that this is one of the safest forms of credit, but also a complex one as it often involves banks in two countries.

Experts at the meeting reported that there are no good data on trade finance. It may be possible to construct such data from figures on short-term finance (collated by the Bank for International Settlements) or on transactions from the bank payments institutions, and there are plans to do this. They believed that the supply had fallen. This is likely at a time when the risks of relying on foreign banks and foreign buyers seem high. The banks involved say that it has (a small number of institutions account for most trade credit, insurance and reinsurance), but there is no certainty.

The impact of any fall would be difficult to measure. The crisis, perhaps aggravated by protection, itself reduces trade, so any fall in trade finance could be the result, not the cause.

Separating any special impact from trade finance from the effects of the general crisis in credit is difficult because in recent years most trade among developed countries

(particularly when it takes place between associated companies) has not been financed by letters of credit, but by general credit to the companies, usually secured on other types of collateral, such as the companies' property and other assets. This type of credit has certainly been badly affected by the financial crisis and the general pessimism about companies' prospects and the prices of their assets. Falls in the supply of this credit will have reduced production of traded goods. The shortages of general credit may have also led to a greatly increased demand for trade credits at a time when the credit system could not respond to this. It is not clear, therefore, whether the wide-spread perception that there is a 'trade credit problem' is correct, or whether trade and the demand for trade credits are simply being affected by the general credit crisis.

Governments have responded by increasing the resources they offer for trade credits, but the lack of information and lack of certainty about prospects mean that they fear being left with the higher-risk loans. The experts disagreed on whether it was right to subsidise trade credit in these circumstances. Such subsidies violate international agreements, but as all countries are doing it, they are unlikely to be challenged.

### **Possible conclusions**

The authors of this pamphlet are right that the world is facing serious threats, and that mistaken action on trade could make them worse. But, up to now, the damage to trade is more the result than the cause of the crisis. So far policy-makers have rightly tried to act on other economic variables, although we cannot know yet if this will be effective.

There are some signs that countries are thinking about using protection against imports, and it will be important to keep a watch on this. This should not mean focusing on 'traditional' risks such as tariffs and subsidies because the potential for changes in these are limited and because experience suggests that protectionist governments will be creative in designing new barriers.

The contraction in finance damages all stages of production. Trade is particularly vulnerable to lack of finance and to the changes in the structure of finance, but here also it is not certain that acting directly on trade finance is the correct response.

International statements in favour of trade without a strong demand for change and commitment to negotiate the detail carry little credibility, whether from the G20, G8, or even a WTO ministerial meeting.