From the Board

The Great Recession and Protectionism

The year 2009 saw the largest drop in international trade since before the origins of the General Agreement on Tariffs and Trade (GATT) in 1947.[1] As a result of the financial crisis, demand plummeted and the ability to finance shipments already on order was severely impaired. In the early part of the year, one could read almost daily headlines that had all the frightening elements of a true global crash – and not many predicting with any confidence whether the end of the year would see the trade and finance system stabilize or continue its slide off the cliff.

The financial crisis generated an increase in trade protectionist measures and a fear that the multilateral trade system rules might not contain this downward spiral. As we go into 2010, most forecasts suggest that the global economy is likely crawling out of recession and even the hardest hit countries may see some growth this year. This makes for an opportune moment to review the response of the multilateral trading system and to consider some of the weaknesses that have been exposed or exacerbated. After all, the system was designed in its original intent to contain its members' worst reactive impulses that follow from severe economic contraction. Current attention is being paid to three aspects: trade policy measures (anti-dumping and countervailing duties (CVDs)); distorting effects of bailouts and discriminatory stimulus; and the trade actions being considered to affect the account imbalances caused by the exchange rate policy of the largest surplus country, notably China.[2] We take them in turn.

Three reports on trade came in near the end of 2009.[3] The first from the World Trade Organization (WTO)[4] concluded that while trade measure and investigations for anti-dumping, CVDs and safeguards had all increased significantly over the twelve months,[5] the impact of these restrictions was nevertheless limited overall to only 1% of global trade flows. The EU's annual trade restriction report also concluded that a worst-case scenario had been avoided, at least for those trade measures (as above) that

[1] Trade contraction forecasted as a decline of 9% for the calendar year of 2009. WTO, PRESS/554, 23 Mar. 2009.

[2] Martin Wolf, 'Why China's Exchange Rate Policy Concerns Us', *Financial Times*, 8 Dec. 2009. See also, Paul Krugman, 'Chinese New Year', *New York Times*, 31 Dec. 2009.

[3] The timeline for all three reports cited here covered the twelve months prior to either October or November 2009.

[4] WTO, Director-General Lamy report, 'Overview of Developments in the International Trading Environment', WT/TPR/OV/12, 18 Nov. 2009.

[5] For anti-dumping, the Lamy report indicated a 15% increase in the year to July of 2009 and predicts 230–250 initiations for all of 2009 compared to 212 in the previous year.

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are well regulated by the WTO.[6] Although over 200 trade restrictive measures had been introduced since October of 2008, the impact had been fairly limited in scope – possibly affecting up to 5% of EU exports.

The EU report did however caution that a variety of 'behind the border' measures also multiplied in the areas where WTO rules are less stringent or non-existent, for example, bailouts, subsidies and public procurement. The Centre for Economic Policy Research (CEPR) Global Trade Alert project put more emphasis on these domestic measures and took a critical view of the G-20 members following their pledge to refrain from introducing new restrictive or discriminatory trade measures during the crisis.[7] Sorting bailouts and procurement stimulus as either discriminatory or not, this report concluded that of the nearly 200 new measures applied by the G-20 members, the discriminatory ones outweighed non-discriminatory ones by a factor of 5 to 1. For its part, the WTO report did not stray deeply into this territory, rather leaving the door open for additional analysis of the effects of stimulus packages on trade. For this it was noted that a methodology for assessing the impact of stimulus would also have to be found that would be supportable by WTO Members.

These summations show that the trading system did its job well where it had the rules to do it. They also raise subjects that could enhance the robustness of the trading system in areas not now covered or incomplete – such as subsidies for services or public procurement. Given the intensity of domestic demands to cope with local economic fall-out, no one expects governments to join in new WTO 'self-restraint' agreements any time soon. But as analysis comes forward one can also expect to see some shifting of priorities in the WTO and its regulatory philosophy of domestic regulation. For example, if procurement agreement members agreed to extend national treatment to cover sectors that now can be targeted to maximize the local impact of a stimulus, should there also be an exception for responding to an economic crisis? Is favouring a local supplier in that environment 'beggar thy neighbour' or a recognition that support for any stimulus is conditioned upon a resulting local benefit.

Going forward, one can also recognize that the picture is incomplete to the extent that some components of the recovery lag behind and that additional protectionist responses are likely. One also considers the longer term fractures that have been exacerbated as a result of the crisis – notably the account imbalances between deficit and surplus countries – and as being discussed, whether the WTO has or should have any role to play in its Members' exchange rate policies to the extent they affect trade.

First, a view that the threat of trade friction is likely to subside because the worst of the crisis is over is looking like a fiction. At least in the United States where consumer credit fuelled trade expansion over the last two decades, unemployment has become the dominant feature on the landscape and the response through 2010 appears solely tuned to addressing employment. Job losses since the end of 2007 and the time likely needed

[6] European Commission, DG Trade Fifth Report on Potentially Trade Restrictive Measures, November 2009.
[7] CEPR, Broken Promises: A G-20 Summit Report by Global Trade Alert, September 2009.

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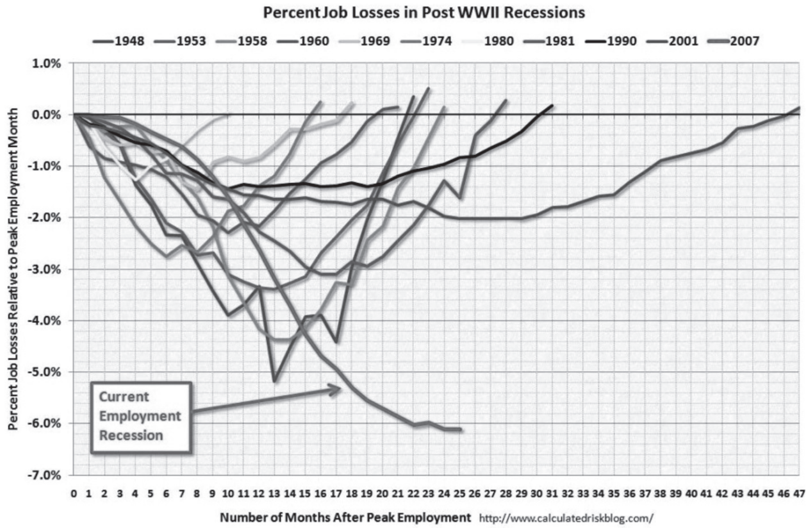

to recover them show this to be far and away the worst of the eleven recessions in the United States since World War II. The current downturn has cut employment by 6% of the work force over the twenty-five months (since December of 2007). While the United States economy is no longer shedding 700,000 jobs each month, it is not yet replacing any of these losses at any discernable pace.[8] By comparison, the deepest post-war recession in 1948 took twenty-two months to recover a loss of 5% employment. The longest post-war recession of 2001 took over forty-six months to regain a job loss of only 2%. The next several months will tell how anaemic this recovery – if it is one – will be for employment. But what is already apparent is that the current contraction is deeper and the recovery likely to be longer then any previous modern experience in the United States.

The unemployment picture in the United States will drive its domestic economic and foreign trade policy for some time to come. Although there is a potential new stimulus in a domestic jobs bill, there is also a budget deficit scare that is rapidly trimming the impulse for additional meaningful stimulus – an idea that may have economic merit but that may become politically unsustainable.

Trade measures will certainly be a continuing part of the theme, particularly as US producers target China's exports. China remains vulnerable to these measures with its large trade surplus, its non-market economy status in anti-dumping actions and the special safeguard clauses available for WTO Members from the China accession protocol. As we saw above, the WTO can handle the complaints and responses. If there are panels

[8] Calculated Risk chart, at <www.calculatedriskblog.com/2010/02/employment-report-20k-jobs-lost-97.html>.

formed on the recent US tires safeguard or any number of anti-dumping investigations, then so be it.

However, the subtext for all these measures and the US-China 'trade war'[9] is increasingly that of China's exchange rate policy, and the question is whether this can be addressed more directly (and coherently) than by the use of trade restrictions bid in by individual sectors. However one characterizes the RMB/dollar exchange rate peg, all agree that the RMB remains significantly undervalued to the dollar. Economist Magazine's Big Mac index places the undervaluation at about 50%.[10] Given that the Euro is about 30% overvalued to the dollar (same index), one can see that the currency question is no minor issue for European recovery either, even while Germany is also one of the larger surplus countries and the Euro area confronts its own 'imbalances' issue. Sarkozy's recent plea at Davos for a return to Bretton Woods and its enforceable system of stable exchange rates is an expression of frustration with China's currency.[11] But while this is also a story in Europe, the trade actions being considered are coming from the United States.

The legal configurations for addressing currency rate actions in either the International Monetary Fund (IMF) or the WTO have been well demonstrated to be very limited.[12] While the IMF Article IV surveillance and consultative mechanism is available – with a number of interpretative issues along the way in respect of China – a mechanism for resolving disputes or sanctioning power is not. Thus, most talk turns to the WTO. GATT Article XV:4 ('Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement ') is considered by most to not refer to exchange rate policies at all. Similarly, considerations of a potential CVD response under the Subsidies and Countervailing Measures (SCM) Agreement in the WTO has also not impressed most legal analysts, although it has been featured in a number of US legislative proposals and trade remedy petitions. There are also suggestions to bring currency rate issues fully into the WTO – an idea that is as interesting in the longer term as it is unfortunately irrelevant in the shorter.

Selective trade measures continue to draw popular support and lower the domestic anger level, but they are cumulatively a mere fraction of the size of the account rebalancing being called for here.

Does this leave us with only the 'dialogue' of trade warfare in a jobless economic recovery? Or as Martin Wolf put it, if the surplus countries insist on sustaining the excess and exporting it, then the choice is a depression (where deficit countries slash spending) or successive waves of fiscal crisis (where deficit countries attempt to stimulate domestic demand). Great choice.

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[9] Elliot Feldman, 'The China-US Trade War', *Law 360* (6 Jan. 2010).

[10] *Economist Magazine*, Big Mac Index (6 Jan. 2010).

[11] *Financial Times*, 'Sarkozy Calls for Action on Currencies' (28 Jan. 2010).

[12] See, e.g., C. Herrmann, 'Don Yuan: China's "Selfish" Exchange Rate Policy and International Economic Law', *Yearbook of International Economic Law* (Springer, 2010).

The US and China currency issue is now reminiscent of the early 1970s when the surplus/deficit between Japan and the United States was at the centre of attention. Some legal commentators who call for a more comprehensive approach to the account balance consider it is time for the United States to examine its options under the balance of payments (BOP) provisions of GATT Article XII and the Balance of Payment Understanding. As Terence Stewart and Elizabeth Drake recall, the United States notified its 10% import surcharge according to Article XII in the late summer of 1971 and then was able to withdraw it four months later following an agreement by the surplus countries to allow their currency rates to float[13] Was it defensible? They cite the IMF Working Party's conclusion that it was 'within the bounds of what was necessary' to prevent further deterioration in the US BOP position. At that time, United States reserves equalled about three months of imports. In 2007, its reserves were adequate to cover eleven days of imports.

For now, the US administration maintains the view that closing the door on China and the other large surplus countries will hurt US trade more than help it. That sounds fine. But the BOP option to this ear is less shrill and more coherently directed to the issue of global economic stability than the ongoing wave of anti-dumping and CVD petitions in the United States. We shall see how the 'open door' commitment sounds around election time in November of 2010.

[13] T. Stewart & E. Drake, 'Addressing Balance-of-Payments Difficulties under World Trade Organization Rules', Economic Policy Institute (EPI) Working Paper, #288, Dec. 2009.