

The Coming Trade Wars

The massive intrusion of government into national economics could spark disastrous protectionism.

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It's hard to find a top economic official, economist or global business leader who doesn't recognize today's heightened dangers of protectionism. U.K. Prime Minister Gordon Brown recently called protectionism the "road to ruin," HSBC chairman Stephen Green has urged governments to "avoid the protectionist errors of the 1930s" and WTO Director-General Pascal Lamy never misses a chance to warn against new tariffs. But it is equally difficult to identify any high-powered efforts to actively ward off the prospect of higher tariffs, quotas or trade-blocking regulations. It is as if talking about the threat is seen as enough to deter a gigantic rollback of global commerce. But rhetoric will not prevent a trade war, which is now, I believe, more likely than it has been at any time since the early 1970s, when currencies were no longer fixed to the value of gold and began to float against one another.

A half-century of steady trade liberalization was in jeopardy even before the current financial and economic meltdown. Prior to the implosion of Bear Stearns, the U.S. Congress had taken away almost all of President Bush's trade-negotiating authority, feeling that the U.S. was no longer gaining enough from new trade agreements, while jobs were being lost and wages undercut. Well before "subprime" entered the popular lexicon, the Doha round of trade negotiations had collapsed, as rich and poor nations fought over contentious issues like agriculture. The rise of China and India has raised deep concerns over import penetration, not just in the U.S. and Europe but also in emerging markets like Mexico. For a few years now, prominent economists such as Princeton's Alan Blinder and Harvard's Larry Summers were raising warning flags that support for free trade was being eroded by the perception that trade was contributing to ever-greater income inequalities.

Now, however, the collapse of the global banking system, a deepening global recession (global growth this year might not reach even 1 percent, according to Goldman Sachs) and the massive intrusion of governments into national economies—a trend that can't help but politicize economic policy decisions—have all added fuel to the fire. Unemployment is growing, with more than 70,000 layoffs announced in the U.S. and Europe last Monday alone, and global trade volume is now decreasing—by more than 2 percent, according to the World Bank—for the first time in a quarter century. Container ships sit idle in ports—demand is down 50 percent year on year. America's own exports declined 6 percent last year, China's 9 percent and Japan's a shocking 35 percent. Trade financing, the essential lubricant of the entire commercial system, has dried up. Slow growth has meant massive industrial overcapacity in heavy industries such as steel, automobiles and electronics, and with global manufacturing dropping at an annual rate of 20 percent, the situation will get much worse. To be sure, we have yet to see a major outbreak of protectionism. Unlike crises in finance, trade problems are slow to emerge, but once the momentum begins, the trend takes years to reverse.

Meanwhile, there are straws in the wind. In the first half of 2008, antidumping investigations around the world were up at least 30 percent. In December, Washington expanded existing sanctions against selected EU food products in retaliation for Europe's boycott of American hormone-treated beef, an old dispute to be sure, but one that is being escalated. Brazil and Argentina are exerting pressure on members of Mercosur, the South American trade block, to raise the group's external tariff. And because the WTO's permissible limits on tariffs level are often much higher than the actual tariffs that countries have imposed in recent years, it is all too possible that governments will now raise tariffs and still be within their legal limits—a blow to trade, whatever the law says. Just last December, after the G20 called on members to resist protection in this troubled times, India raised tariffs on steel, iron and soybeans, and four other governments in the group gave notice that they too were planning to raise tariffs. In the next few weeks, the Obama administration will be deciding whether to file a large suit in the WTO against China's subsidization of exports, potentially upping global trade tensions by orders of magnitude.

But the most dangerous trade conflicts may stem not from wrangling over traditional subsidies or tariffs, but from the new fiscal stimulus plans being launched around the world to counter the economic downturn. In recent months, politicians have been encouraging consumers to, in the words of the Spanish industry minister Miguel Sebastian, "buy patriotically." Now as one country after another enacts major stimulus packages, they are sure to attempt to limit government procurement to domestic producers. The current U.S. House of Representatives version of the \$825 billion stimulus bill, for example, is already riddled with "Buy America" legislation mandating that the money or subsidies go exclusively to U.S. makers of steel, cement, etc.

Beyond that, the efforts of many governments to bail out entire industries risk taking on a protectionist tone. Washington is again a case in point as it spends billions to rescue Detroit's Big Three, with not a penny going to Toyota or BMW, both of which are hurting from the downturn and both of which are gigantic investors in the U.S. and employers of tens of thousand of Americans. Another looming problem could concern the aircraft industry, as just last week the French government decided to subsidize financing for Airbus not just with normal export financing but with money heretofore reserved for rescuing banks. How long before Washington and Boeing follow suit?

In the stimulus and bailout cases, this kind of discrimination between "domestic" and "foreign" companies is exactly what trade negotiations since 1947 have tried to combat. Foreign investment is the lifeline for many nations, and distinctions between foreign and domestic firms are increasingly blurred. Complex global supply chains crisscross the world, making discrimination on the basis of nationality a throwback to another age and a monkey wrench in the machinery of modern global commerce.

Another palpable protectionist threat is the possibility of competitive currency devaluations. The problem could be particularly acute among Asian countries, which collectively rely on exports for more than 40 percent of their GDP. At his recent Senate confirmation hearings, U.S. Treasury Secretary Timothy Geithner accused China of intentionally holding down the value of the yuan as a subsidy to its exporters. He threatened to kick off serious negotiations with China that could, if unsuccessful, lead to trade sanctions. This was a much harder line against China than the Bush administration followed, made all the more dramatic because it was the first thing the new administration has said about the country on which so much of America's future depends.

Since the 1950s, the U.S. has led the charge for dismantling global trade barriers. Yet, during the recent presidential election, then candidate Barack Obama seemed ambivalent about this legacy, with his call to renegotiate NAFTA and his almost blanket support for the policies of the protectionist labor unions. Now, with trade tensions sure to rise, the president must change his tune and become a global leader.

First, he must establish the policy that open trade is a crucial part of a global stimulus package. He should make it clear that exports are a critical generator of high-paying jobs and that imports hold prices down for millions of Americans.

Second, while he has already acknowledged the very real problem of income inequality, he must now address it directly. The solutions fall into the realm of education, training, trade-adjustment assistance, health care, community development and tax policy. Trade barriers are not the right instrument because that would raise prices for the poor and middle class and make the U.S. less competitive, and because other countries will retaliate in kind and kill our much-needed exports. Without a full-court press to reduce income inequalities, forestalling a trade debacle, let alone fostering trade liberalization, is politically impossible. The irony is that all these policies are already addressed in the new stimulus package. Obama needs to explicitly make the political and economic connection by emphasizing that the right domestic cushions will be in place to allow us to benefit from open trade.

Third, when the G20 heads of state meet on April 2 in London, the Obama administration should have prepared the way for a ringing endorsement to fight protectionism, with several concrete protrade commitments. Chief among these would be a set of rules to prevent stimulus packages and bailouts from discriminating against foreign investors.

Finally, Washington must deal with one of the most horrendously challenging problems of the world economy: how to reduce global financial and trade imbalances by encouraging Asian economies to spend more at home and consume more, too, and at the same time getting the U.S. to save and produce more. The U.S. could begin by examining a revised tax system that taxes consumption and rewards savings. China could be encouraged to vastly strengthen its social safety net so that consumers feel more secure about not saving so much of their income. A joint U.S.-China commission to study the alternatives and methods of implementation and report back in 2010 might be a good starting point. This is the long-term way to a sustainable equilibrium in the world economy, but the effort must begin now.

If there is a serious deterioration of global commerce due to protectionism, the damage would include slower growth everywhere. It would be impossible to restructure large global industries such as auto and steel, and there would be major difficulties further integrating China, India, Brazil, Russia and others into the global economy—with an attendant rise of political confrontations.

The banking crisis combined with deteriorating growth could deal a body blow to globalization. A trade war would be the coup de grâce.

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