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A Protectionism Fling
Why Tariff Hikes and Other Trade Barriers Will Be Short-Lived

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Introduction

During the past six months governments have intervened massively in the financial and real sectors of their economies, reviving debate over policies long considered vanquished. Some governments have turned to protectionism, raising tariffs and other barriers to trade. Others are subsidizing industries or more quietly finessing regulatory policies to advantage domestic "champions." Surely, the temptation to placate powerful domestic interests will lead other governments toward protectionism in the months ahead.

A sense of foreboding seems to have enveloped the trade policy community, where a common view among scholars, economists, and journalists is that a resurgence of protectionism is inevitable, and that it will cause serious economic damage. In the newspaper columns and in the think tank reports, there is little evidence of any faith that the rules-based system of trade—established in part for the purpose of containing and defusing protectionist outbursts—is equipped to rise to what is arguably the first major challenge in its 62-year existence.

But that view does not adequately reflect the fact that most governments prefer policies that keep their economies open to trade and investment. Despite some episodes of backsliding, the world is unlikely to witness a significant departure from the trend toward trade and investment liberalization that has been evident since the end of World War II. An increasing number of governments have come to recognize that optimal economic outcomes arise under conditions where policies enhance—rather than limit—the freedom of people to transact with others, including foreigners. Protectionism limits choices and thereby undermines human liberty and economic efficiency.

Reasonably well-respected trade rules and the reality of a global economic system that renders trade openness an imperative for success are some of the reasons to believe that any protectionist outbreak will be fleeting. Indeed, policymakers would be advised to respond to the downturn by *reducing* their trade and investment barriers unilaterally because doing so expands choices, reduces costs, and spurs the kinds of structural reforms that facilitate economic growth.

A System to Bend but Not Break

One of the reasons for the creation of the rules-based system of trade was to ensure that the scenario of spiraling, retaliatory protectionism of the 1930s never played out again. Starting with the General Agreement on Tariffs and Trade in 1947, through seven subsequent multilateral rounds of trade liberalization culminating in the establishment of the World Trade Organization in 1995, and into the present, that objective has been upheld.

The WTO/GATT rules encourage trade liberalization, but also grant governments some flexibility to manage their own paces of liberalization and to re-impose or raise barriers under certain circumstances. The rules distinguish between "Bound" and "Applied" tariff rates. The bound rate is the maximum rate of duty (per product category) that a member can assess against imports, and the applied rate is the prevailing rate of duty (per product category). Generally, the bound rates of developed countries are significantly lower than the bound rates of developing countries. That is, the highest allowable tariffs in richer countries are much lower than the highest allowable tariffs in poorer countries.[1]

Within the rules, developing country economies are considered more vulnerable to potentially disruptive effects of rapid changes brought about by increased trade and investment. Accordingly, governments of developing countries are afforded greater latitude to respond to those changes. How much latitude depends, to some extent, on the differences between each country's bound and applied rates. If the applied rate relative to the bound rate is low, then there may be vast room for backsliding and raising tariffs in response to a perceived crisis. For many developing countries, the differences are vast.

India's simple average bound tariff rate is 50.2 percent, but its simple average applied rate is 14.5 percent. Thus, the Indian government could almost quadruple its tariffs without violating its WTO obligations. Likewise, Brazil has a lot of "overhang" with an average bound rate of 31.4 percent and an average applied rate of 12.2 percent. By contrast, China has far less latitude for backsliding. Its average bound rate is 10.0 percent, and its average applied rate is 9.9 percent. The institutional restraint on China's backsliding is similar to that on developed countries. The bound and applied rates of the United States are both 3.5 percent, and for the European Union (27) the bound rate is 5.4 percent and the applied is 5.2 percent.[2] Many factors affect a member's bound rates, including its level of development, its duration as a member of the WTO/GATT, and its past negotiating positions, to name a few.[3]

Other forms of temporary backsliding also are permitted within the system. Members can raise tariffs in excess of their bound rates, impose quotas, and even ban imports altogether under various WTO agreements. The Agreement on Safeguards permits members to impose duties or quotas in response to unforeseen import surges, which seriously injure a domestic industry. Under the Anti-dumping Agreement, duties can be imposed when a domestic industry is materially injured by reason of imports that have been sold at prices below "normal value."[4] The Agreement on Subsidies and Countervailing Measures permits members to impose duties to offset the injurious effects on a domestic industry from imports that benefit from foreign government subsidies.

Under the rules, imports also can be banned in the interest of public health or safety. Some member countries have used these provisions to exclude imports of beef that were suspected of contamination from "mad cow" disease. Others have banned genetically modified agricultural products on the grounds that the risks of consumption are presently unknown.

Protectionism on the Rise?

C. Fred Bergsten of the Peterson Institute for International Economics finds that "The WTO rules are very porous. If you simply say live up to your rules, you still have massive scope for what I call legal protectionism."[5] But Bergsten sees the glass as half empty. Sure, there is scope for backsliding, but without that scope in the first place the WTO/GATT system likely never would have come to succeed as it has. Governments would have been less willing to formalize commitments and the scope of rules coverage would have been smaller in terms of products and countries involved.

Still even more importantly, the trade rules are not so restrictive that governments obsess over finding ways around them. It is not the existence of the rules that compels countries to liberalize trade. Governments typically are not looking for excuses to raise trade barriers. If compliance were the primary motivation for countries to liberalize trade, we would not observe applied tariff rates that are so much lower than the maximum allowable rates. And we would likely observe much greater use of the various trade remedies across industries and more invocation of restrictions in the name of health and other technical barriers to trade.

Trade liberalization is motivated by self-interest, and the disparities between bound and applied rates are explained by the fact that most members have a preference for openness. There are real benefits, beyond the reciprocal openings of others' markets, to keeping one's own trade barriers low. Nevertheless, governments have been invoking protectionist measures over the past several months. Here are just a few examples:[6]

- In India, tariffs and other restrictions have been raised on some steel products;
- Ecuador raised tariffs on 940 different products by a range of 5 to 20 percentage points;
- Indonesia limited the number of points of entry into domestic commerce for imported products and is requiring its civil servants to buy only Indonesian-made products; and
- Argentina made licensing requirements more onerous for so-called sensitive products, such as auto parts, textiles, TVs, and shoes.

And here is how a top-circulation American daily newspaper described the global flirtation with trade barriers in December:

> Moving to *shield battered* domestic manufacturers from foreign imports, Indonesia is *slapping* restrictions on at least 500 products this month, demanding special licenses and new fees on imports. Russia is hiking tariffs on imported cars, poultry and pork. France is launching a state fund to protect French companies from foreign takeovers. Officials in Argentina and Brazil are seeking to raise tariffs on products from imported wine and textiles to leather goods and peaches.[7]

There may be nothing necessarily incorrect about the facts reported. But the tone and implications are possibly misleading. It is hard to accept the otherwise marginally significant facts without also accepting the provocative metaphors and sense of impending doom. Those actions have less antagonistic explanations and more benign interpretations.

The actions of Indonesia, Argentina, and Brazil are consistent with their rights under the WTO agreements and will have a negligible collective impact on world trade. Russia is not even a member of the WTO and frequently behaves outside of international norms, so its actions have very limited representative value. And France has intervened to block foreign takeovers of French companies on other occasions this decade, so its actions are not particularly noteworthy. The popular media usually lacks nuance in its accounting of trade policy events and often intones that the present will be a replay of the 1930s.

A Little Perspective, Please

Although some governments will dabble in some degree of protectionism, the combination of a sturdy rules-based system of trade and the economic self interest in being open to participation in the global economy will limit the risk of a protectionist pandemic. According to recent estimates from the International

Food Policy Research Institute, if *all* WTO members were to raise *all* of their applied tariffs to the *maximum* bound rates, the average global rate of duty would double and the value of global trade would decline by 7.7 percent over five years.[8] That would be a substantial decline relative to the 5.5 percent annual rate of trade growth experienced this decade.[9]

But, to put that 7.7 percent decline in historical perspective, the value of global trade declined by 66 percent between 1929 and 1934, a period mostly in the wake of Smoot Hawley's passage in 1930.[10] So the potential downside today from what Bergsten calls "legal protectionism" is actually not that "massive," even if *all* WTO members raised *all* of their tariffs to the *highest* permissible rates.

If most developing countries raised their tariffs to their bound rates, there would be an adverse impact on the countries that raise barriers and on their most important trade partners. But most developing countries that have room to backslide (i.e., not China) are not major importers, and thus the impact on global trade flows would not be that significant. OECD countries and China account for the top two-thirds of global import value.[11] Backsliding from India, Indonesia, and Argentina (who collectively account for 2.4 percent of global imports) is not going to be the spark that ignites a global trade war. Nevertheless, governments are keenly aware of the events that transpired in the 1930s, and have made various pledges to avoid protectionist measures in combating the current economic situation.

In the United States, after President Obama publicly registered his concern that the "Buy American" provision in the American Recovery and Reinvestment Act might be perceived as protectionist or could incite a trade war, Congress agreed to revise the legislation to stipulate that the Buy American provision "be applied in a manner consistent with United States obligations under international agreements." In early February, China's vice commerce minister, Jiang Zengwei, announced that China would not include "Buy China" provisions in its own $586 billion stimulus bill.[12]

But even more promising than pledges to avoid trade provocations are actions taken to *reduce* existing trade barriers. In an effort to "reduce business operating costs, attract and retain foreign investment, raise business productivity, and provide consumers a greater variety and better quality of goods and services at competitive prices," the Mexican government initiated a plan in January to unilaterally reduce tariffs on about 70 percent of the items on its tariff schedule. Those 8,000 items, comprising 20 different industrial sectors, accounted for about half of all Mexican import value in 2007. When the final phase of the plan is implemented on January 1, 2013, the average industrial tariff rate in Mexico will have fallen from 10.4 percent to 4.3 percent.[13]

And Mexico is not alone. In February, the Brazilian government suspended tariffs entirely on some capital goods imports and reduced to 2 percent duties on a wide variety of machinery and other capital equipment, and on communications and information technology products.[14] That decision came on the heels of late-January decision in Brazil to scrap plans for an import licensing program that would have affected 60 percent of the county's imports.[15]

Meanwhile, on February 27, a new free trade agreement was signed between Australia, New Zealand, and the 10 member countries of the Association of Southeast Asian Nations to reduce and ultimately eliminate tariffs on 96 percent of all goods by 2020.

While the media and members of the trade policy community fixate on how various protectionist measures around the world might foreshadow a plunge into the abyss, there is plenty of evidence that governments remain interested in removing barriers to trade. Despite the occasional temptation to indulge discredited policies, there is a growing body of institutional knowledge that when people are free to engage in commerce with one another as they choose, regardless of the nationality or location of the other parties, they can leverage that freedom to accomplish economic outcomes far more impressive than when governments attempt to limit choices through policy constraints.

A Growing Constituency for Freer Trade

The WTO/GATT system was created in the first place to deter a protectionist pandemic triggered by global economic contraction. It was created to deal with the very situation that is at hand. But in today's integrated global economy, those rules are not the only incentives to keep trade barriers in check. With the advent and proliferation of transnational supply chains, cross-border direct investment, multinational joint ventures, and equity tie-ups, the "Us versus Them" characterization of world commerce no longer applies.

Most WTO members are happy to lower tariffs because imports provide consumers with lower prices and greater variety, which incentivizes local business to improve quality and productivity, which is crucial to increasing living standards. Moreover, many local economies now rely upon access to imported raw materials, components, and capital equipment for their own value-added activities. To improve chances to attract investment and talent in a world where capital (physical, financial, and human) is increasingly mobile, countries must maintain policies that create a stable business climate with limited administrative, logistical, and physical obstacles.

The experience of India is instructive. Prior to reforms beginning in the 1990s, India's economy was virtually closed. The average tariff rate on intermediate goods in 1985 was nearly 150 percent. By 1997 the rate had been reduced to 30 percent. As trade barriers were reduced, imports of intermediate goods more than doubled. The tariff reductions caused prices to fall and Indian industry suddenly had access to components and materials it could not import previously. That access enabled Indian manufacturers to cut costs and use the savings to invest in new product lines, which was a process that played a crucial role in the overall growth of the Indian economy.[16]

India's approach has been common in the developing world, where most comprehensive trade reforms during the past quarter century have been undertaken unilaterally, without any external pressure, because governments recognized that structural reforms were in their country's interest. According to the World Bank, between 1983 and 2003, developing countries reduced their weighted average tariffs by almost 21 percentage points (from 29.9 percent to 9.3 percent) and unilateral reforms accounted for 66 percent of those cuts.[17]

The Indispensible Nation

The United States accounts for the highest percentage of world trade and has the world's largest economy. The WTO/GATT system is a U.S.-inspired and U.S.-shaped institution. Recession in the United States has triggered a cascade of economic contractions around the world, particularly in export-dependent economies. Needless to say, U.S. trade policy is closely and nervously observed in other countries.

But despite the occasional anti-trade rhetoric of the Democratic Congress and the protectionist-sounding campaign pledges of President Obama, the United States is unlikely to alter its strong commitment to the global trading system. There is simply too much at stake. Like businesses in other countries, U.S. businesses have become increasingly reliant on transnational supply chains. Over 55 percent of U.S. import value in 2007 was of intermediate goods, which indicates that U.S. producers depend highly on imported materials, components, and capital equipment. And there is also the fact that 95 percent of the world's population lives outside of the United States, so an open trade policy is an example to uphold.

Finally, the President has made it a priority to restore squandered U.S. credibility with the international community. That objective cannot be fulfilled by acting in a multilateral, internationalist manner on foreign policy, while acting in a provocative or unilateralist manner on trade policy because, for most countries, U.S. trade openness and engagement is the form of diplomacy that matters most. Accordingly, the president will have to thwart the Congress's sometimes combative, unilateralist tendencies on trade policy if he hopes to restore U.S. foreign policy credibility.

Conclusion

Despite the global economic contraction and the occasional protectionist indulgence, there is reason to be hopeful that retrogressive policies will be marginal, short-lived, and ultimately rejected. The absence of trade rules in the 1930s meant that there were no proffered courses of action, no sources of adjudication or remediation, and no generally accepted limits to the actions governments could take in response to external economic policies. And there were far fewer domestic constituencies of any political consequence advocating against protectionism in the '30s. Consequently, there were no proven stopgaps to prevent the pandemic of spiraling protectionism that erupted and exacerbated the global recession.

Today we have the benefit of understanding the consequences of the actions taken in the 1930s. Although that understanding does not guarantee avoidance of past mistakes, we also have solid institutions and incentives to help steer policymakers away from the abyss. The rules governing more than 60 years of trade liberalization have fostered greater certainty and stability, and thus more investment, trade, and economic growth. And today, the commercial and political appeal of protectionism is considerably diminished because most countries have established domestic constituencies that depend on a trade and investment environment that is open in both directions.

Notes

1. *World Tariff Profiles 2008*, World Trade Organization (Switzerland: 2008).
2. Ibid.
3. See ibid. for references to tariff rates. China's relatively rigid situation stems from the fact of its late accession to the WTO, in 2001. It had to appease the wishes of many more established members to win approval for its own membership, whereas India's relatively flexible situation owes to its longer standing membership and its participation in previous negotiating rounds.
4. For a detailed analysis of antidumping rules, see Brink Lindsey and Dan Ikenson, "Antidumping 101: The Devilish Details of 'Unfair Trade' Law," Cato Institute Trade Policy Analysis no. 20, November 26, 2002.
5. Steven Mufson, "WTO Seeks to Curtail Protectionist Measures," *Washington Post*, February 6, 2009, p. D03.
6. "Report to the Trade Policy Review Board from the Director-General on the Financial and Economic Crisis and Trade-Related Developments," World Trade Organization, Document no. JOB(09)/2, January 26, 2009.
7. Anthony Faiola and Glenn Kessler, "Trade Barriers Toughen with Global Slump," *Washington Post*, December 22, 2008, p. 1. Emphasis added.
8. Antoine Bouet and David Laborde, "The Potential Cost of a Failed Doha Round," International Food Policy Research Institute Issue Brief 56, December 2008, http://www.ifpri.org/pubs/ib/ib56.pdf.
9. World Trade Organization statistics, http://www.wto.org/english/res_e/statis_e/its2008_e/section1_e/i01.xls.
10. U.S. Department of State, "Smoot-Hawley Tariff," description provided at http://future.state.gov/when/timeline/1921_timeline/smoot_tariff.html.
11. World Trade Organization, *International Trade Statistics, 2008*, data downloaded from http://stat.wto.org/Home/WSDBHome.aspx?Language=E.
12. United Press International, "China Rejects 'Buy China' Policy," February 9, 2009.
13. Government of Mexico, Economic Secretary, "Mexico Launches a Phase Down Plan to Reduce Import Rates," *NAFTA Works (A Monthly Newsletter on NAFTA and Related Issues)*, http://www.naftamexico.net/naftaworks/nw2009/Jan09.pdf.
14. Government of Brazil, Brazilian Foreign Trade Chamber (CAMEX), *Official Gazette*, Resolution nos. 4 and 5, February 4, 2009.
15. "In Response to International Pressure, Brazil Cuts Import Restrictions," *Latin American Herald Tribune*, January 30, 2009.
16. Vidya Mahambare, "Trade Protectionism Cannot Fight Economic Crisis," Rediff.Com, December 12, 2008.
17. World Bank, "Global Economic Prospects: Trade, Regionalism, and Development," 2005, p. 42.