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# The Global Economic Downturn and Protectionism

**Raymond J. Ahearn**
Specialist in International Trade and Finance

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# Summary

In today's severe global economic downturn, concerns are being raised that countries may try to improve their own trade positions in order to help domestic industries at the expense of others by imposing measures that artificially increase their exports or restrict imports. Such efforts are considered by some to be a form of "protectionism" and are often referred to as beggar-thy-neighbor policies.

This report develops three scenarios to approximate different dimensions of the relationship between the global economic downturn and protectionism. The scenarios are not predictions, but descriptions of how and why pressures for protection could be manifested and transmitted under different circumstances and assumptions.

Under a **low impact scenario**, existing World Trade Organization (WTO) rules and obligations, bolstered by a high level of global interdependence, discourage trade restrictions and trade diverting measures from being proposed. If implemented, the measures conform to WTO rules and/or have a limited impact on trade flows. Recent reports issued by the WTO and World Bank provide preliminary support for this scenario.

Under a **medium impact scenario,** WTO rules are violated or are disregarded due to the exigencies of the economic crisis and demands to provide financial rescue plans for the banking and auto sectors. As a result, trade and investment flows over time could be diverted or fall outside WTO surveillance, thereby weakening the global trading system.

Under a **high impact scenario,** WTO rules are violated, major trade conflict occurs, and the world trading system is undermined. This threat arises from the longstanding presence of large trade imbalances driven by distorted global consumption and savings patterns—patterns that were an underlying cause of the global economic downturn. Given the prominent role that China and the United States play in the global imbalances, two flashpoints for any outbreak of protectionism can be identified. The first could stem from U.S. public concerns that other countries are gaining a "free ride" in terms of international efforts to increase aggregate spending and get the world economy growing again. The second could arise if China and other surplus countries try to avoid massive factory closings and layoffs by exporting their overcapacity to the United States and Europe with trade policy measures such as export subsidies and currency depreciation.

Three broad policy challenges for Congress are derived from the analysis. The first deals with international surveillance of fiscal stimulus programs. The second relates to multilateral surveillance of trade pressures and barriers proposed and adopted during the economic crisis. The third pertains to the joint management of U.S. trade relations by Congress and the administration, particularly as it bears on responding to constituent requests for protection, facilitating the adjustment of current account surplus countries, and formulating trade liberalization priorities.

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# Introduction

The world economy may now be undergoing its most severe crisis since the Great Depression. The economies of the United States, Japan, and Europe are in recession and the emerging economies in Asia and Latin America are experiencing slower, if not negative, growth as well. According to the International Monetary Fund (IMF), world economic activity is projected to contract by ½ to 1 percent in 2009, the first such fall in 60 years.[1]

As economic activity has slowed around the globe and trade finance has become harder to obtain, world trade flows have also declined. The decline, which began in the summer of 2008, has affected all the major trading countries. Overall, the World Bank is predicting that world trade flows will decline by 2 percent in real terms in 2009 after growing by 4 percent in 2008. This may prove to be optimistic; early 2009 data show signs of sharper declines in export volumes, particularly among the open Asian export economies such as Singapore, Taiwan, and China.[2]

Emblematic of these concerns, the leaders of the most-developed G-20 countries proposed at a November 2008 meeting "to refrain from raising new barriers on trade in goods and services" for at least 12 months. Underlying this declaration was a view that government efforts to shield local companies from the global economic downturn through the imposition of trade barriers would only curb economic growth and prolong the global downturn. More starkly, there was an additional concern that a rise in trade barriers could turn the global downturn into a global depression. In the view of some analysts, this is what happened in the 1930s as a result of the passage of the U.S. Smoot-Hawley Tariff Act of 1930, an event which triggered a cycle of retaliation and counter-retaliation.

**Smoot-Hawley Tariff Act**

The Smoot-Hawley Tariff Act of 1930 raised U.S. tariffs on over 20,000 products to an average level of 60 percent. After the U.S. passed the bill, other countries retaliated by raising their barriers to U.S. exports. World trade flows incurred a severe 66 percent drop between 1929 and 1934. Some economists argue that this huge drop in trade was what made the Depression great, by prolonging and deepening what had been a global recession. Other economists argue that U.S. tariffs were already quite high and that other factors such as misplaced faith in reliance on the gold standard and balanced budgets were bigger causes of the Great Depression. Greater consensus appears to exist on the notion that it is far better to keep markets open and increase world demand than to divert demand in national markets to domestic producers by raising trade barriers during a global recession.

The specter of widespread protectionism or trade wars currently is the subject of numerous newspaper and press articles.[3] Until recently it was possible to dismiss many mass media alarms on the grounds that today's global economy has numerous firewalls against protectionism that did not exist in the 1930s. But the accelerating global economic decline has increased pressures on policymakers to adopt a number of measures to assist distressed industries that are considered by some observers to be "protectionist."

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1 *International Monetary Fund,* IMF Survey Online, March 19, 2009.

2 Alan Beattie, "Policymakers Strive to Explain Plunge in Trade," *Financial Times,* March 9. 2009.

3 See Carter Dougherty, "Protectionism: The View from Europe," *New York Times,* March 9, 2009; Catherine Rampell, "The Contagion of Protectionism," *New York Times,* March 6, 2009; Anthony Faiola, "Trade Barriers Threaten Global Economy: World Bank Finds Protectionist Trend," *Washington Post,* March 18, 2009; Jeffrey E. Garten, "The Dangers of Turning Inward," *The Wall Street Journal,* March 1, 2009; and Ariana Eunjung Cha, "U.S.-China Trade Ties Erode Amid Accusations From Each Nation Complaining of Protectionism," *Washington Post,* February 20, 2009.

Protectionism is a very elastic concept with multiple meanings. For many economists, no form of protection is legitimate because such interventions distort prices and misallocate resources over time. For some trade lawyers, only measures that are not consistent with WTO rules and obligations are protectionist and considered unacceptable. For many political realists and policymakers, protective measures that provide help to constituents in times of economic distress are a political responsibility and necessity, not protectionism. For some historians, efforts by countries to improve their own trade position and help domestic industries at the expense of others by imposing measures that artificially increase exports or limit imports describe protectionism. Still other historians define protectionism as a return to the policies of the 1930s, which are characterized by substantial across the board increases in trade barriers often directed at particular countries and cycles of retaliation and counter-retaliation.

To analyze the relationship between the economic downturn and protectionism, this report constructs three scenarios. Each scenario reflects a different dimension of the relationship between the economic downturn and protectionism. The scenarios are a continuum based on an analysis of the situation today to the direction that trade protectionism could take under different assumptions and circumstances. The scenarios are not predictions, but descriptions of how and why protectionist pressures could be manifested and transmitted under very different situations and policy responses.

Under a **low impact scenario** existing WTO rules and obligations, bolstered by a high level of global interdependence, keep pressures for protection under control. Proposals for protection, if implemented, have a modest impact on global trade flows.

Under a **medium impact** scenario WTO rules prove inadequate or are disregarded due to the exigencies of the economic crisis. As a result, trade and investment flows over time could be diverted or fall outside WTO surveillance, thereby weakening the world trading system.

Under a **high impact scenario** WTO rules are violated or ignored, major trade conflicts occur, and the world trading system is damaged. This threat arises from longstanding trade imbalances driven by distorted global savings and consumption patterns.

The depth and duration of the economic downturn likely will be a major determinant of which scenario or scenarios prevail. At the same time, the degree to which protectionist measures are adopted could affect the course of the economic downturn as well.

A concluding section discusses several policy challenges that rising pressures for trade protection may pose for policymakers and the 111th Congress. This issue is also bound to be on the agenda of the G-20 countries when the leaders meet in London on April 2, 2009 to coordinate responses to the global economic crisis.

# Low Impact Scenario: Firewalls Hold As WTO Rules and Obligations Constrain Protectionist Measures

There are a number of reasons why the threat of a return to protectionist, beggar-thy-neighbor policies could be vastly overstated. Unlike the 1930s, today's global economy has several strong firewalls to prevent governments from raising trade barriers that result in a cycle of retaliation and counter-retaliation. These firewalls include more institutionalized obstacles to protectionism built into the WTO system, more policy instruments to address the economic slowdown, and a more interdependent and open world economy than existed in the 1930s.

In addition, some in today's media may tend to overstate the threat of protectionism by not always distinguishing between protectionist actions and protectionist pressures and/or by equating legitimate forms of protection with protectionism. The fact that there is ample room for increases in trade measures and barriers that are consistent with the rules and obligations of the WTO often may go unappreciated in some press coverage. These trade measures and barriers include increases in applied tariffs to bound rates, and imposition of countervailing and antidumping duties, so-called 'defensive' trade measures.[4] Protection for limited periods of time and under prescribed conditions is built into the rules of the WTO as a political safety valve and as a recognition of the human and social costs that are associated with the often wrenching adjustments that accompany increased trade competition.

## Firewalls Against Protectionism

WTO rules today serve to keep a lid on trade barriers of its 153 members through an elaborate set of mutual obligations and dispute settlement procedures. Unlike the 1930s when countries could impose higher trade barriers unilaterally without violating any international agreements or anticipating a foreign reaction, under today's rules members can take their disputes to the WTO for settlement rather than engaging in reciprocal retaliatory actions. The fact that countries violating WTO obligations can face WTO-sanctioned retaliation helps constrain outbreaks of unilateral actions that could be mutually harmful.[5]

Pressures for protection are also dampened by a world economy that is much more interdependent and integrated than in the 1930s.[6] Leading producers have become so international in their production operations and supply chains that they have developed a vested interest in resisting protectionism.[7] Many industries that have faced import competition in the past – such as televisions and semiconductors—have found that international diversification or joint ventures with foreign partners are a more profitable way of coping with global competition than blocking goods at the border. In addition, many domestic industries have less incentive to ask for import restrictions because foreign rivals now produce in the domestic market, eliminating the benefits of trade barriers for domestic firms.[8]

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[4] Some 26 WTO members, including Australia, Brazil, India, and South Korea, impose tariffs (so-called "applied" tariffs) that average roughly 8 percent. Because these tariffs have not been "bound" through WTO negotiations, they could be raised as high as 28 percent on average without breaking any WTO rules or requirement to compensate affected trade partners. The potential costs if these countries decided to increase tariff rates to their bound level to protect domestic industries are potentially significant, decreasing world trade by an estimated 7.7 percent. See Antoine Bouet and David Laborde, "The Potential Cost of A Failed Doha Round," *International Food Policy Research Institute,*, Issue Brief 56, December 2008.

[5] Paul Blustein, "The Nine-Day Misadventure of the Most Favored Nations: How the WTO's Doha Round Negotiations Went Awry in July, 2008," *Brookings Institution*, 2009.

[6] The simple average share of world trade to GDP, which is 96% today compared to 70% in 1970, illustrates the increased interdependence. Source: World Bank.

[7] Dick K. Nanto, *Globalized Supply Chains and U.S. Policy,* CRS Report R40167, *Globalized Supply Chains and U.S. Policy,* by Dick K. Nanto, January 16, 2009.

[8] Douglas A. Irwin, "Trade Policy in 2008: Great Depression Redux?", In *What World Leaders Must Do to Halt the Spread of Protectionism,* Richard Baldwin and Simon Evenett, editors, A VoxEU.org Publication, Centre for Economic Policy Research (CEPR) 2008, p. 61.

Unlike the early 1930s, when governments took little responsibility for propping up financial institutions and were unable to pursue expansionary monetary policies due to fixed exchange rates under the gold standard, policymakers around the world today are adopting expansionary fiscal and monetary policies. These expansionary policies, in turn, have the capability of dampening protectionist pressures and demands that stem from job losses and related economic hardship with lower interest rates and increased expenditures on unemployment benefits and health care benefits.[9]

A related consideration is that today's world economy is much more open than the world economy of the 1930s. Average tariffs on world trade have come down from the 50% range in the 1930s, to the 25% range in the 1980s, and to less than 10% today.[10] Under these circumstances, it would require tremendous increases in protection to get the world back to anywhere near the conditions of the 1930s, although a major increase in tariffs (e.g. a doubling) would be disruptive even if it left tariffs well below the 1930s levels.

## Scorecard of Protective Measures To Date

Empirical support exists for the view that existing legal, economic, and political firewalls are restraining today's protectionist pressures. Most importantly, Pascal Lamy, the WTO's Director General, reported in January 2009 that most WTO members have successfully kept domestic protectionist pressures under control "with only limited evidence of increases in trade restricting or trade distorting measures" taken during the last six months of 2008. This assessment was based on the first report of the WTO secretariat on the trade effects of the global economic crisis. The report found only "limited evidence" of an increase in tariffs, non-tariff barriers or trade-remedy actions by member countries, but noted that the most significant actions taken in response to the global crisis have involved "financial support of one kind or another to banks and other financial institutions and to certain industries, notably the automobile industry."[11]

The WTO report notes tariff increases on selected products being implemented by India, Russia, Ecuador, and Ukraine. Countries adopting non-tariff measures include Indonesia (port of entry barriers) and Argentina (import licensing requirements). Argentina was cited for measures that attempt to boost exports of selected products. But the report indicates that there has been "no dramatic increase" in antidumping investigations in the second half of 2008 compared to first half of 2008, but raised the possibility of increased trade remedy actions in 2009.[12]

The World Bank, which has also been monitoring trade restrictions proposed and adopted since the beginning of the financial crisis, reached a conclusion similar to that of the WTO. Its initial report determined that there have been 47 trade restrictive measures imposed since the financial crisis began last summer, including 17 from G-20 countries, but that "these measures have probably had only marginal effects on trade flows to date." In addition to the measures cited by the WTO, the World Bank report cited China's import ban on various food products from the EU, and export subsidies provided by the EU, China, and India. Contrary to the WTO report, the

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[9] Wendy Dobson, "Keeping the Global Economy Open," In Richard Baldwin and Simon Evenett, p. 28.

[10] There are wide variations among countries between agricultural and manufactured goods.

[11] WTO Staff, "Report to the TPRB From the Director-General on the Financial and Economic Crisis and Trade-Related Developments," JOB(09)2, January 23, 2009.

[12] Bureau of National Affairs, "WTO Report Finds Limited Impact So Far Of Financial Crisis on Higher Trade Barriers," *International Trade Reporter*, January 27, 2009.

World Bank report determined that "the number of antidumping cases (both investigations initiated and imposition of duties) surged in 2008."[13]

## Proposals Modified

Further support for the "firewalls are holding" perspective can also be found in the evolution of proposals for protection that have been either modified or withdrawn. The two most prominent cases that fit this description are a Buy American provision contained in the U.S. stimulus legislation (P.L. 111-5, Sec. 1605),[14] and a French proposal to require its carmakers to produce and source locally.

As originally passed by the House on January 28, 2009, the stimulus bill contained a provision that would have required the use of U.S. iron and steel for infrastructure projects funded by the bill. The Senate's amended version of the provision, which prevailed in conference, went further in requiring the use of U.S. manufactured goods (in addition to iron and steel) in specified projects, but also included language requiring that the provision had to be implemented in a manner consistent with U.S. international trade obligations. This language was vigorously supported by U.S. multinational companies and trading partners such as the European Union and Canada.

Some observers maintain that the Buy American provision agreed to in the stimulus bill may have only a very limited impact on international trade flows. This is because the law waives Buy American restrictions according to a number of broad public interest tests, including if "the relevant manufactured goods are not produced in the United States in sufficient and reasonably available quantities." With imported goods now comprising nearly 40% of all manufactured goods sold in the United States, imports in a large number of areas may not be constrained.[15]

Supporters also say the Buy American provision is the kind of measure that is often dubbed "protectionist" on questionable grounds. Up until 1979, when the Tokyo Round of trade negotiations reached agreement on a voluntary Agreement on Government Procurement (AGP), government procurement was entirely excluded from international trading system obligations. Today only 39 of 153 WTO members have joined the AGP, an agreement that opens up government procurement according to negotiated sectors, agencies, and thresholds. The limited nature of the AGP reflects, in part, the fact that government procurement decisions are still viewed largely as a means of achieving legitimate domestic policy goals, including increasing the probability that public spending will generate domestic jobs.[16]

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[13] Elisa Gamberoni and Richard Newfarmer, "Trade Protection: Incipient but Worrisome Trends," *World Bank*, VOX, March 4, 2009.

[14] The provision provides that none of the funds appropriated or otherwise made available by the act may be used for a project for the construction, alteration, maintenance, or repair of a public building or public work unless all of the iron, steel, and manufactured goods used in the project are produced in the Unites States provided such action would not be inconsistent with the public interest, such products are not produced in the United States, and would not increase the cost of the overall project by more than 25%. U.S. major trading partners have similar buy domestic provisions.

[15] Louis Uchitelle, "Buy America' in Stimulus (but Good Luck With That)," *New York Times*, February 21, 2009. Much of the actual impact will depend on how the various federal agencies interpret and administer the provision. In the past, U.S. agencies have shown flexibility in interpreting specific definitions and vague language in a way that has been consistent with U.S. international trade obligations.

[16] Buy American provisions, in different forms, have been a significant response to the belief that U.S. products and materials in some circumstances should be protected to some degree from foreign competition in order to obtain the (continued...)

Opponents dispute the claims that this provision may have a small impact on international trade and is not "protectionist." A key assertion is that many major U.S. trading partners that are not signatories to the AGP, such as Brazil, China, and India, will face discrimination in bidding on the projects covered by the law. Facing such discrimination, these countries may decide to retaliate by pressuring their companies perhaps to buy from European producers instead of U.S. suppliers or by pursuing their own buy-national policies. For example, while China recently removed from one of its recent stimulus bills a provision instructing "governments of different levels to give priority to home-grown light-industry products," the mere public introduction of the clause reportedly has been enough to get provincial authorities to favor local over foreign suppliers in the procurement of a broad range of products.[17]

The French government's decision in February 2009 to provide $3.9 billion in preferential loans to Renault and Peugeot-Citroen was similarly controversial due to buy-local or buy-national concerns. As a condition for the loans, it was initially reported that the French government was requiring these two automakers to source from French suppliers and to close factories in other countries to ensure that car factories located in France keep operating. This apparent effort to prevent outsourcing of French car production provoked a strong reaction from the Czech Republic and Slovakia, countries where Peugeot-Citroen had factories. The Czech Republic immediately called for an emergency European summit to protest France's "protectionist plan" and the European Commission (EC) agreed to investigate what appeared to be a violation the EU's single market rules.[18] After weeks of discussion with the EC, French authorities pledged not to implement measures that would breach the principles of the single market by requiring manufacturing activities to be maintained in France.[19]

# Medium Impact Scenario: WTO Rules Prove Inadequate, Particularly for Sector-Specific Assistance, and Trading System Is Weakened

Under this scenario, WTO rules and obligations are disregarded or prove ineffective and trade and capital flows are diverted or misallocated. As a result, the global trading system could be weakened over time.

This scenario involves sector specific financial assistance programs that governments around the world have developed in response to the economic crisis. To date these programs have been directed primarily to auto companies and banks. In the auto sector, almost every producing country—the United States, Canada, Sweden, Germany, France, Australia, Argentina, Brazil, South Korea, and China – has launched programs to aid producers or stimulate car sales. One estimate totals these subsidies at $48 billion worldwide, including $17.4 billion thus far in the

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biggest bang for the buck from federal spending. Critics respond that federal spending would yield the biggest bang for the buck by sourcing inputs and goods internationally.

[17] *The Economist*, "The Next Great Wall: Buy Local Campaigns Raise Protectionist Barriers in Asia," March 14, 2009.

[18] Ben Hall and Peggy Holinger, "France Opts for 6 Billion Euro Car Bail-Out," *Financial Times*, February 10, 2009.

[19] Niki Tait, "Brussels and France Resolve Auto Dispute," *Financial Times*, March 2, 2009.

United States. In the financial services sector, the WTO reports that 58 different programs worth trillions of dollars have been announced by 26 countries in an effort to strengthen struggling institutions.[20]

These financial assistance programs have been devised and implemented in response to extraordinary conditions. In the financial sector, as some major banks and institutions have appeared on the edge of bankruptcy, government rescue packages and takeovers have increased in scope and magnitude in an effort to avoid contagion or systematic risk—not by a desire to save failing companies. The destruction of wealth in the financial sector has also hurt the real economy and key industrial sectors, with large firms facing bankruptcy and large cut-backs in their labor force.

While alleged subsidies contained in the rescue packages under some circumstances can improve national economic performance and resource allocation, they may also be a vehicle for a kind of murky protection and misallocation of resources. Whether any of the many different rescue packages discriminate against foreign firms may also become an important consideration in judging their impact on the trading system over time.[21]

## Auto Sector Rescue Programs

Slumping sales and employment have led the major auto producing countries to adopt or consider a range of financial assistance programs. The measures vary in the degree to which they help companies directly through loans and guarantees or indirectly through tax incentives and credits for buying new cars. The programs also differ to the extent they try to insure that only domestic companies may benefit. Because many of these programs are still evolving or lack publicly-announced details, the trade consequences are mostly speculative.

Some experts have argued that these assistance programs could be challenged as violations of the subsidies rules under the WTO Agreement on Subsidies and Countervailing Measures (ASCM). Under Article 3 of the ASCM, subsidies that are contingent upon export performance or upon the use of domestic over imported goods are prohibited. Countries could also challenge another country's assistance programs on the grounds that loans were not provided on a commercial basis. However, such a challenge would also need to prove that trade injury occurred (either "serious prejudice" or a "threat of serious prejudice") to car producers of other WTO signatories. This could prove a difficult hurdle since several years of evidence are required to show that imports have been displaced or impeded, prices have been suppressed or undercut, and imports have lost market share.[22]

As a practical matter, many observers think that WTO cases are unlikely to be filed. This is because a country bringing the challenge could expect that its own auto industry assistance program could be similarly challenged. Considerable cross-ownership of companies complicates such filings as well. In addition, foreign carmakers operating in the United States, such as Toyota

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[20] Elisa Gamberoni and Richard Newfarmer, p. 3.

[21] Simon J. Evenett and Frederic Jenny, "Bailouts: How to Discourage a Subsidies War," In Richard Baldwin and Simon Evenett, *The Collapse of Global Trade: Murky Protectionism and the Crisis: Recommendations for the G20*, A VoxEU.org Publication, Centre for Economic Policy Research (CEPR), 2009.

[22] *Inside U.S. Trade*, "Possible U.S. Auto Bailout Could Face WTO Challenge By EU," November 21, 2008.

and Honda, may be unwilling to support any WTO complaint given that they have received tax-breaks or subsidies to build factories from U.S. state governments.[23]

Foreign auto-assistance measures such as loans or loan guarantees could also be challenged under each country's countervailing duty (CVD) laws.[24] If successful, countervailing duties could be imposed to offset any competitive advantages that an auto exporting company may have received from its government. Such cases must meet similar tests to a challenge under the ASCM, but it is the industry, rather than the government, that would bring a case. While it could be easier to obtain an affirmative finding in a countervailing duty case because national authorities, not WTO panels, make the injury determinations, these cases can take up to two to three years to resolve. Assuming a duty eventually was imposed on imported autos, a car company in the targeted country could file a similar case against the country that imposed the duty.[25] If the CVD cases proved successful, subsidies may stay in place and generate inefficient production over time, with world trade in autos becoming more fragmented and protected.[26]

Other concerns have been raised beyond trade diversion. One is that the various subsidy packages being implemented around the world may not only strain national budgets, but also result in a misallocation of resources. Firms that have access to the largest subsidies, under this perspective, will be able to ride out the global economic downturn longer, raising concern that access to state funds rather than commercial viability determines success.[27]

Another concern is that more industries will be encouraged to lobby for preferential financing, encouraging a subsidy race in other sectors. For example, auto parts manufacturers in some countries are now requesting assistance similar to what the automakers have received.

A final concern is that the auto industry could become isolated from WTO rules and disciplines, similar to the situation in the shipbuilding and steel industries. Under this perspective, if countries set up their own criteria for permissible subsidies with little regard for market conditions, the world trading system could be weakened.[28]

## Financial Sector Rescue Programs

As the financial crisis has spread over the world, governments have launched extensive rescue programs for troubled banks and other institutions, along with other monetary and fiscal policy initiatives. For example, Iceland has nationalized all its major banks, and the United Kingdom has taken a 68% share of the Royal Bank of Scotland.[29] The United States has taken control over Fannie Mae and Freddie Mac and has extended billions of dollars to American International

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[23] *Inside U.S. Trade,* "Experts Say Auto Bailout Provides Illegal WTO Benefit, Risking Trade," December 26, 2006

[24] CVD laws are designed to offset to any unfair competitive advantage that foreign manufacturers or exporters may enjoy over domestic producers as a result of foreign countervailable subsidies.

[25] This challenge would have to be heard domestically and would not constitute tit for tat retaliation.

[26] Claire Brunel and Gary Hufbauer, "Money for the Auto Industry: Consistent with WTO Rules," *Peterson Institute for International Economics,* Number PB09-4, February 2009, p. 10.

[27] Simon J. Evenett and Frederic Jenny, p. 84.

[28] Claire Brunel and Gary Hufbauer, pp 9-10.

[29] Landon Thomas, Jr., "Nationalized in All But Name: U.S. Move Echoes U.K. Share of RBS," *International Herald Tribune,* February 24, 2009, Internet edition.

Group (AIG) and Citigroup.[30] In U.S. cases, the government has received interest or equity stakes in return for assistance with the subsidy element taking the form of more favorable terms and financing than the companies could receive on the open market.

From a trade perspective, a concern is that some governments, like Britain, are directing their banks with global operations to lend to domestic companies and citizens before providing loans to foreigners. While these actions may not violate any international legal obligations (WTO rules regulating assistance to financial institutions lag behind those regulating assistance to goods producers), this form of financial protectionism may undermine the spirit of globalization that supports an open world trading system.[31] At the same time, it can be noted that there has been substantial international cooperation in the financial sphere among the key central banks of the world to deal with the financial crisis.

# High Impact Scenario: WTO Rules Are Violated, Major Trade Conflicts Occur, And Trading System Is Undermined

Under this scenario, WTO rules are violated or ignored and major trade conflicts occur. As a result, the functioning and legitimacy of the world trading system is undermined.

This threat arises from the longstanding presence of highly skewed trade balances driven by distorted global consumption and savings patterns—patterns that were an underlying cause of the global economic downturn. High savings countries such as China, Japan and Germany produced more than they consumed and had to rely on export-led growth to help keep their economies growing. In the process, these three countries, plus the oil-exporting countries, experienced large and growing current account surpluses.[32] In 2008, the current account surpluses were estimated to be around $2 trillion.[33] The United States, on the other hand, was a low savings country, consuming much and having to borrow from the rest of the world to finance its investment needs.

## Re-balancing Trade Flows

Overall trade imbalances are caused by different international savings and investment levels. Much of the earnings of the current account surplus countries were recycled to U.S. capital markets in the form of purchases of U.S. securities, helping make capital abundant and cheap in

[30] Binyamin Appelbaum, "Government to Take Bigger Stake in Citigroup," *Washington Post*, February 27, 2009.

[31] Anthony Faiola, "Out of Gaps in Treaties, First Salvos of Trade War," *Washington Post*, January 1, 2009.

[32] The current account is the broadest measure of a country's international transactions and includes trade in goods, services, investments, and unilateral transfers. A surplus means that outflows of currency resulting from these transactions are less than inflows, and a deficit means that outflows of currency resulting from these transactions exceed inflows. Thus, a current account surplus country is a net exporter of investment funds to the rest of the world, and a current account deficit country is a net importer or recipient of investment funds from the rest of the world.

[33] The oil exporters generated $813 billion, China $399 billion or 9.5% of GDP, Germany $279 billion or 7.3% of GDP, and Japan $194 billion or 4% of GDP. Cited in Martin Wolf, "Global Imbalances threaten the survival of liberal trade," *Financial Times*, December 2, 2008.

the United States.[34] Cheap and abundant capital, in turn, facilitated rising levels of U.S. consumption and investment in housing.[35] When U.S. consumption began to contract due to the rapid decline in housing prices and the credit crisis, the pattern of global trade and financial flows was no longer tenable.[36]

Policies that correct the imbalances and provide for more balanced growth in the next decade are important both for a global economic recovery and an avoidance of an outbreak of trade conflict. For current account deficit countries like the United States, where domestic spending exceeds current production, spending must decline and savings rise. This can be achieved by a reduction of consumption or investment (or a combination of both).[37] This, of course, is happening quickly in the United States with rising unemployment and the credit crunch forcing drastic reductions in domestic spending, particularly investment spending.[38] The U.S. current account deficit has now begun to fall, from 6% of GDP in 2006 to 4.5% in 2008, and possibly to 3% or even 2% in 2009.[39]

For the current account surplus countries, the rapid U.S. adjustment means that they will have to sustain their growth more by stimulating domestic demand and less by net exports. For these countries, where domestic spending is less than current production, domestic spending will need to rise. This, in turn, can be accomplished by increases in consumption, investment, or government spending (or a combination of all three). While expansive government spending programs or higher domestic consumption generally are the preferred path for the demand increases to take place, sharp reductions in supply or production in current account surplus countries are also possible. For example, China, the largest current account surplus country, would have to be able to increase its consumption to an estimated 17% of GDP—a 40% expansion—to offset the expected decline in U.S. consumption of 5% of GDP. It has been argued that this would be a huge adjustment, and one that is perhaps beyond the ability of government spending programs alone to stimulate.[40] Given the prominent role that China and the United States play in the global imbalances, two flashpoints for any outbreak of protectionism can be identified. The first involves the possibility that some countries could be perceived as "free riders" in the international effort to increase global aggregate demand. The second relates to the daunting task many countries, particularly China, Japan and Germany, face in shifting their economies towards a greater reliance on domestic demand.

[34] CRS Report RL34742, *The Global Financial and Economic Crisis: Analysis and Policy Implications*, by Dick K. Nanto, James K. Jackson, Wayne M. Morison, J. Michael Donnelly, Martin A. Weiss, Ben Dolven, William H. Cooper, J. F. Hornbeck, February 20, 2009.

[35] U.S. Joint Economic Committee, "Chinese FX Interventions Caused International Imbalances, Contributed to U.S. Housing Bubble," by Robert O'Quinn, March 2008.

[36] Robert Samuelson, "Three Crises in One," *Washington Post,* January 26, 2009.

[37] The other large current account deficit countries in descending order are Spain, the United Kingdom, France, Italy, and Australia.

[38] In the short-run, U.S. policy is attempting to boost spending and reduce savings in order to soften the downturn, which paradoxically makes the goal of rebalancing more difficult in the long-run.

[39] William R. Cline, "Trade, Finance, and the Global Recession," p.8, and CRS Report RL33577, *U.S. International Trade: Trends and Forecasts, U.S. International Trade: Trends and Forecasts,* By Dick K. Nanto, Shayerah Ilias, and J. Michael Donnelly, p.27.

[40] William R. Cline, and Martin Wolf, "Why Obama Must Mend A World Economy," *Financial Times,* January 20, 2009.

## Dealing with Fiscal Stimulus "Free Riders"

This flashpoint stems from the need for an increase in global aggregate demand to rescue the world economy from a continuing downward slide. To offset retrenchments in private consumption, investment, and exports and to avoid the trade imbalances of the past, countries are being urged to adopt coordinated fiscal stimulus packages. But some concerns have emerged in the United States, which has adopted a $787 billion stimulus program, over the size and composition of the plans and commitments of other G-20 countries.[41] These concerns have been directed primarily towards China and some European countries.[42]

China, which adopted a $585 billion stimulus program in November 2008, has been urged to spend more given its huge holdings of foreign reserves, as well as to make its spending more transparent. For example, it is unclear how much of the spending from China's November stimulus will be new expenditures versus already announced plans. Plus it is unclear how much of the new spending will benefit industrial development and China's exporting industries versus consumers and domestic demand.[43]

France, the United Kingdom, and Germany are European countries that some observers believe could be doing more to support world demand. According to IMF staff estimates (**Table 1**), their stimulus packages as a percent of GDP tend to lag behind the U.S. and Chinese plans.

**Table 1. Stimulus Packages in Large Countries**

(in percent of GDP)

| | 2008 | 2009 | 2010 | Total |
|---|---|---|---|---|
| United States | 1.1 | 2.0 | 1.8 | 4.8 |
| China | 0.4 | 2.0 | 2.0 | 4.4 |
| Germany | 0.0 | 1.5 | 2.0 | 3.4 |
| Canada | 0.0 | 1.5 | 1.3 | 2.7 |
| Japan | 0.4 | 1.4 | 0.4 | 2.2 |
| United Kingdom | 0.2 | 1.4 | -0.1 | 1.5 |
| France | 0.0 | 0.7 | 0.7 | 1.3 |
| India | 0.0 | 0.5 | ....... | 0.5 |
| Italy | 0.0 | 0.2 | 0.1 | 0.3 |
| Average | 0.5 | 1.6 | 1.3 | 3.4 |

**Source:** International Monetary Fund, "The Size of the Fiscal Expansion: An Analysis for the Largest Countries," Fiscal Affairs Department, February 2009.

**Notes:** PPP GDP-weighted average.

[41] The stimulus package, of course, is controversial in the United States.

[42] Landon Thomas Jr. and Julia Werdigier, "No Clear Accord on Stimulus By Top 20 Industrial Nations," *New York Times,* March 15, 2009.

[43] For an critical analysis suggesting that China's stimulus program will do little to stimulate imports and domestic consumption, see Derek Scissors, "China's Stimulus Plan: Repackaged and Misdirected," *Heritage Foundation,* Web Memo #2128, November 10, 2008.

These European countries counter that the relative size of various stimulus packages need to account for spending on automatic stabilizers such as unemployment benefits, health care, and training. Given that European countries tend to have larger such expenditures, an IMF analysis taking these expenditures into account indicates much stronger contributions to global demand are being made by Germany, the United Kingdom and Italy and a much weaker contribution being made by China (see **Table 2**).

The IMF analysis also points out that due to already large public debt, some countries, like India, Italy, and Japan, have less "fiscal space" or leeway to undertake expansionary fiscal policies. In addition, some countries may be reluctant to undertake a fiscal expansion because the recession is not yet deep for them. And some developing countries may be unable to use fiscal stimulus because of fears that investors will lose confidence in their credit worthiness. Moreover, in every polity, including the United States, there are stakeholders opposed to the use of expansionary fiscal policy on the grounds that it either won't work or will pass on to future generations debt that current citizens should pay.

**Table 2. Change in Overall Fiscal Balance**

(in percent of GDP, relative to pre-crisis year 1/)

| | 2008 | 2009 | 2010 | Average |
|---|---|---|---|---|
| United States | -3.5 | -5.7 | -6.1 | -5.1 |
| Germany | .... | -3.2 | -4.4 | -3.8 |
| United Kingdom | -1.5 | -4.6 | -5.4 | -3.8 |
| Japan | -1.3 | -3.7 | -3.7 | -2.9 |
| India | -2.6 | -3.3 | -2.2 | -2.7 |
| Canada | -0.9 | -2.9 | -3.2 | -2.4 |
| China | -1.1 | -3.0 | -3.0 | -2.3 |
| France | -0.6 | -2.8 | -3.6 | -2.3 |
| Italy | -1.1 | -2.4 | -2.8 | -2.1 |

**Source:** International Monetary Fund, "The Size of the Fiscal Expansion: An Analysis for the Largest Countries."

**Notes:** Pre-crisis year is 2007, except for Germany (2008).

While the United States is the world's largest economy and perhaps the only one capable of increasing global demand quickly, it is no longer large enough to be the single locomotive of the world economy or the global consumer of last resort. Because stimulus in any country will boost demand for both domestically produced goods and imports, the United States needs help from the other trade surplus countries to spur its exports and economic growth at a time when its spending and consumption are being diffused to help countries like China that are the world's major producers. Absent such help, some observers say protectionist pressures could grow in the United States if the large U.S. stimulus increases U.S. indebtedness by far more than it increases demand for U.S. goods.[44] Stated differently, if the U.S. economy after a year or two has little to show for running expansionary policies and incurring increased public debt—for example, unemployment remains high, there is little or no economic recovery, and the increased public debt begins to

[44] Martin Wolf, "Global Imbalances Threaten the Survival of Liberal Trade," *Financial Times, December 2, 2008.*

weaken the value of the dollar[45]—the American public may ask why such a large share of U.S. stimulus spending is leaking abroad and generating jobs in countries that have not stimulated their own economies sufficiently to increase imports of U.S. products.[46]

The fiscal policies of the countries with large external surpluses, thus, are critical for the world economy to recover in a timely manner and, over time become more balanced in terms of spending patterns relative to production. In a deep recession, some analysts maintain that failure of the current account surplus countries to increase domestic demand in a substantial manner is a form of a beggar-thy-neighbor policy as they import demand from the rest of the world. According to this perspective, current account surplus countries are also exporting their unemployment to the rest of the world and "cannot be surprised if deficit countries even resort to protectionist measures."[47] Interestingly, the United States was the world's largest current account surplus country in the 1930s, and, thus, was essentially in China's position today.

**United States and Current Account Surpluses in the 1930s**

The trade and financial imbalances that were an underlying cause of today's global economic crisis were in some ways similar to the imbalances that characterized the world economy in the 1920s and 1930s. During this period, the United States was the largest current account surplus country, financing the deficits of countries in Europe with capital exports through bonds floated by foreign countries in New York. These capital exports allowed a number of European countries to continue to run large deficits, while the United States continued expanding its industrial capacity. The financial crisis of 1929-31 led to a collapse of the bond market, effectively cutting off funding for the current account deficit countries and their ability to buy U.S. goods. This drop in foreign demand, in turn, forced the United States to either increase domestic demand or cut back on domestic production. But instead of running an expansionary fiscal policy (increasing domestic demand), the United States cut back spending and then in 1930 enacted the Smoot-Hawley Tariff. The trade deficit nations retaliated, raised their own tariffs, and world trade collapsed. This forced most of the global adjustment (deep production cuts and high unemployment) on the United States and other current account surplus countries in Latin America. Deficit countries such as Germany, Italy, and Spain suffered much less. (Most economists think that the main reason the Depression was milder in some countries was due to the fact that they abandoned the gold standard more quickly than the United States, thereby giving them greater flexibility to run expansionary fiscal policies). One tentative implication is that if today's crisis were to lead to a trade war, all countries would be worse off, but surplus countries, especially China, would suffer the most. Source: Michael Pettis, "Asia Faces a Tough 2009 as Output Decreases," *Financial Times,* December 15, 2008, and Martin Wolf, "What Obama Should Tell the Leaders of the Group of 20," *Financial Times,* February 25, 2009.

## Current Account Surplus Countries – Transitioning To Domestic-Led Growth

A second flashpoint relates to the task that many countries, particularly China, Japan, and Germany, face in shifting their economies towards greater reliance on domestic demand – that is producing more for themselves rather than exporting to the rest of the world. Stated differently, these countries need to reduce their heavy reliance on exports by reorienting their economies

[45] To date this has not happened as global investors continue to buy U.S. bonds, strengthening, rather than weakening, the value of the dollar. See Peter S. Goodman, "A Rising Dollar Lifts the U.S. but Adds to the Crisis Abroad," *New York Times,* March 9, 2009.

[46] Michael Pettis, "Would A Trade War Solve the Problem of Excess Capacity," *Emerging Capital Markets Economic Monitor,* November 17, 2008.

[47] Martin Wolf, "Why Saving the World Economy Should Be Affordable," *Financial Times,* March 18. 2009.

more towards domestic consumption and investment. But for a variety of cultural, political and economic reasons, the transition may be extremely difficult.

In the case of China, efforts to increase consumption and domestic demand will not be easy or quick. Chinese households, for example, have one of the highest savings rates in the world (up to 25%). Chinese families, especially those in rural areas, save at such high rates because they receive little government support with education costs, medical care, and retirement. The average hospital stay can cost the equivalent of two years wages for the average Chinese worker. In addition, some of the items Chinese people may want to consume are not necessarily the goods being produced for export. Some production, thus, may need to be re-engineered and some workers retrained and re-deployed because China's economy biases the economy towards exports rather than domestic consumption. Yet, requests from factory managers to make goods for the domestic market may take up to two years for all the necessary approvals to be made. Moreover, lending of the Chinese banking system continues to be biased towards boosting manufacturing and infrastructure projects, not consumer spending.[48]

Japan's longstanding export dependence has been fueled by a mind-set of export or perish. Based on a shortage of natural resources, most Japanese have adopted a mercantilist perspective tied to the notion that Japan's power is dependent upon exporting manufactured goods in exchange for raw materials and generating trade surpluses with the rest of the world. This mind-set has been bolstered by a banking system that places priority on allocating credit to big exporting companies.

Given that Japan's economy declined by 3% in the last quarter of 2008, there may be added urgency for the government to undertake additional spending programs. For such spending to generate increases in private demand, much of the new money would have to be channeled to education, housing, and improving Japan's health care infrastructure. Hundreds of thousands of small- and medium-sized businesses, which employ two-thirds of Japan's workforce, stand to benefit from a redirection of credit.[49] At the same time, Japan has had interest rates near zero for several years and still has been unable to stimulate domestic demand.

Germany's economy is heavily dependent on the world economy for its growth as well. It is the world's largest exporter of goods and 25% of its jobs are export dependent. Moreover, it has objected to implementing larger spending programs on historical and structural grounds. Savings were wiped out by policies that created hyperinflation in the 1920s and German economic policy, ever since the end of World War II, has emphasized stability over economic growth. Opposition to additional spending, thus, is rooted in both fears of its inflationary impact, plus concerns that additional debt could be a drag on growth in the future. Because the economic crisis to date has had few palpable effects on ordinary Germans (except for their automobile industry), efforts to induce already high saving Germans to spend any extra cash could prove difficult.[50]

Assuming the transition to domestic-led growth by China takes years to accomplish, a major concern is that the current account surplus countries could try to avoid massive factory closings by resorting to tariff and trade policies designed to export their overcapacity to the rest of the

[48] Keith Bradsher, "As Trade Slows, China Rethinks Its Growth Strategy," *New York Times*, January 1, 2009, and Steven Pearlstein, "Asia, Europe Find Their Supply Chains Yanked, Beware the Backlash," *Washington Post,* February 20, 2009.

[49] David Pilling, "Japan's New Carry Trade, The Handbag," *Financial Times,* January 22, 2009.

[50] Carter Dougherty and Judy Dempsey, "Leary of Debt, Germany Shuns a Spending Spree," *Financial Times,* March 10, 2009.

world. This concern was highlighted by one Chinese trade official who recently stated that "China will resort to tariff and trade policies to facilitate exports of labor-intensive and core technology-supported industries."[51]

Providing export subsidies, increasing import tariffs, and depreciating a currency were the tools most often utilized in the 1930s to boost exports. As the history of this period demonstrated, countries cannot all export their way to growth unless they collectively act to boost imports. Without an import boost, trade tensions will likely escalate and possibly lead to serious trade conflicts.

# Policy Challenges for Congress

The global economic downturn is deep and broad. Job cuts and declining levels of economic activity are affecting countries around the globe. Even before the crisis hit, there had been an erosion of public support for trade and globalization in many countries, including the United States. As a result, increased pressures for protection should not be unexpected.

Policymakers and Members of Congress, thus, find themselves situated between a rock and a hard place. On the one hand, they are under increased pressure to respond to pleas from voters to take action that will alleviate immediate distress. On the other hand, they are cognizant of the need to keep markets open and trade and investment flowing. How to balance considerations of constituent requests for relief—national and political demands—with recognition of the growing imperatives of an integrated global economy—which requires international cooperation—is an overarching dilemma.

In this context, three broad policy challenges can be derived from the analysis presented in this report. The first deals with international coordination and surveillance of fiscal stimulus programs. The second relates to multilateral surveillance of trade pressures and barriers adopted during this crisis. The third pertains to the management of U.S. trade relations, particularly as it relates to trade with China and other current account surplus countries.

## Coordination and Surveillance of Stimulus Programs

Most economists maintain that governments need to place high priority on bolstering aggregate demand in an effort to arrest deteriorating economic conditions around the world. Expansionary economic policies, via tax cuts, increased public spending, and budget deficits, are one way to get national and global economic activity moving again. In addition to its beneficial impact on bolstering global demand and addressing the recession, such policies can also be channeled to alleviating some of the losses (jobs and health care benefits) workers are experiencing from the economic downturn—losses that often intensify protectionist pressures.

Expansionary policies, including monetary policies, are not universally supported. Some critics worry about consequences of larger public debt. Many European governments maintain that financial regulatory reforms are a more important priority.[52] Other critics believe that it is more

[51] Keith Bradsher, "As Trade Slows, China Rethinks its Growth Strategy," *New York Times,* January 9, 2009.

[52] Edward Cody, "E.U. Pushes Strict Regulations Over More Stimulus Spending," *Washington Post,* March 21, 2009.

efficient to allow markets to adjust without government interference. And still others maintain that expansionary policies are unlikely to prove sufficient in achieving long-term rebalancing of domestic demand.

The current account surplus countries generally are in the best position to run expansionary fiscal policies.[53] Such policies are also necessary if current account deficit countries, which are trying to save more than before, are able to improve their net export position, a development critical for economic recovery. Moreover, the United States, the world's largest deficit country, will be hard pressed to employ expansionary economic policies for many years without adverse consequences for the value of the dollar and its overall debt position. In the absence of help from these countries, political frustration in the United States could grow if it is perceived that other countries are shirking their global economic responsibilities.

Under these circumstances, it could prove helpful if policymakers and Members of Congress had available an objective analysis of the extent to which all major countries are pursuing expansionary policies, given their differential circumstances. Such public information could be used in discussions with their counterparts (in all major countries) to do their "fair" share in keeping the world economy moving forward and as a way to hold everyone to account. The analysis could include targets for demand growth and monetary policy, perhaps differentiated by individual country circumstances. U.S. Treasury Secretary Tim Geithner has called for each G20 country to set a spending target equaling 2 percent of aggregate GDP for 2009 and 2010, and for the IMF to monitor progress towards that goal.[54] Some economists are calling for a more ambitious 3 percent spending target given the deterioration in the outlook for world economic growth.[55]

The IMF's Fiscal Affairs Department has produced an analysis that addresses this objective in part. Whether such an analysis or macroeconomic scorecard could benefit from a formal mandate from the leadership of the IMF or the G-20 countries is something that could be considered.[56]

## Multilateral Surveillance of Trade Barriers

The WTO Secretariat has begun tracking trade and trade-related measures taken in the context of the current economic crisis. These efforts are designed to bolster policymakers' resolve to reject calls for protection by making the measures transparent and public. The idea is that by raising public awareness of what barriers are being imposed, countries may realize that they are not acting alone and that their restrictive measures could be emulated quickly by their trading partners.[57]

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[53] The IMF analysis relies on the size of a country's output gap and the amount of "fiscal space" as determined by levels of deficits, public debt, and interest rates as key determinants of the magnitude of a country's overall fiscal expansion. See IMF Staff Analysis, pp. 3-4.

[54] Alan Beattie, "IMF Firepower to Triple," *Financial Times,* March 12, 2009.

[55] C. Fred Bergsten, "Needed: A Global Response to the Global Economic and Financial Crisis," Testimony before the Subcommittee on Terrorism, Nonproliferation and Trade, Committee on Foreign Affairs, U.S. House of Representatives, March 12, 2009.

[56] Martin Wolf, "What Obama Should Tell the Leaders of the Group of 20," *Financial Times,* February 25, 2009.

[57] Richard Baldwin, "The Crisis and Protectionism: History Doesn't Repeat Itself, But Sometimes It Rhymes," In Richard Baldwin and Simon Evenett, p. 33.

An initial concern about the WTO effort is that the data have been drawn primarily from secondary sources such as press reports. Member governments currently are obliged to notify the WTO about changes in applied tariffs and subsidies only on an annual basis. For the tracking system to become more useful and relevant, there may be a need for greater involvement of member governments in providing information on new measures adopted. Along with this information, the member country could be asked to provide some justification for taking the action, along with a promise to remove the new protection within a certain period of time.

It also has been suggested that an inventory of new protective measures, many of which are likely to be WTO-consistent or legal, could also prove useful once the global recession ends. Much of the damage from the higher tariffs of the 1930s was that they remained in place for decades. Thus, devising a plan to remove the barriers induced during the economic crisis arguably could also be contemplated.[58]

## Management of U.S. Trade Relations

The global economic downturn creates numerous challenges for Congress and the President in managing U.S. trade relations. Based on a longstanding division of responsibilities -- Congress's constitutional responsibility to "regulate foreign commerce" and presidential responsibility to negotiate with foreign countries—the legislative and executive branches of government are challenged to consult and cooperative closely. This is true on a range of issues, including constituent requests for protection, facilitating the adjustment of current account surplus countries, and formulating trade liberalization priorities.

### Responding to Requests for Protection

As constituent requests for protection are likely to increase as the recession persists, Congress is faced with balancing the political imperative of being responsive to constituent needs against U.S. international obligations under the WTO. On the one hand, current WTO and other international trade obligations do grant member countries some leeway to raise tariffs, protect domestic producers for limited periods of time, and provide domestic preferences or financial assistance to specific sectors under certain circumstances. Such protection provides a political safety valve for absorbing the political pressures associated with efforts of companies and workers to adjust to increased competition. On the other, protection that falls outside existing international trade obligations has less legitimacy. Under these circumstances, the policy challenge is not necessarily protection versus no protection, but under what circumstances might protection be appropriate and for how long. As the history of U.S. trade policy suggests, providing no protection when it may be warranted can often backfire, generating support for greater and perhaps excessive protection at a later date.[59]

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[58] Kevin H. O'Rourke, "Engage Multilateral Institutions In Solutions To Today's Problems," In Richard Baldwin and Simon Everett, p. 56.

[59] Raymond J. Ahearn and Alfred Reifman, "U.S. Trade Policy: Congress Sends A Message," In Current U.S. Trade Policy: Analysis, Agenda, and Administration, *NBER Conference Report,* Robert E. Baldwin and J. David Richardson, editors, 1986.

## Dealing with Current Account Surplus Countries

How best to facilitate a more rapid adjustment of current account surplus countries is a second large challenge for Congress and the Executive Branch. Legislative initiatives threatening trade sanctions, for example, are likely to hurt both sides if imposed, but they could also provide the President with useful leverage in pressing counterparts in Europe and Asia to do more in terms of boosting aggregate demand.

In an ideal world, international cooperation and institutions are a better way to encourage the current account surplus countries to undertake necessary structural changes and to head off protectionist actions. As part of any agreement, a realistic amount of time may be required for these countries to make the necessary adjustments. In return for open markets in the deficit countries while these changes are being made, the surplus countries could agree not to employ predatory trade policies.[60]

Problems and possible conflict likely will occur, however, if it becomes clear that current account surplus countries are trying to export their overcapacity and unemployment to the United States by manipulating their exchange rate, subsidizing exports, or blocking imports.[61] Challenging these practices through the available international channels may be less politically contentious and more effective than unilateral actions, but such challenges can often take years to be resolved. In the meantime, trade can take on a zero sum game appearance as the choice between preserving jobs at home or abroad becomes more stark.

## Considering the Role of Trade Liberalization

A third challenge for the Congress and Administration involves weighing the role that trade liberalizing agreements can play during the current recession. On the one hand, in a time of great economic uncertainty and retrenchment, many stakeholders may prefer to preserve benefits (subsidies or tariffs) that they already have. This is because trade liberalization rests on a willingness to swap current benefits derived by protection or subsidies in return for future benefits offered by promises of greater access to foreign markets that are growing. On the other hand, trade liberalization, by cutting protection, may provide an effective economic stimulus and, in the process, appear more attractive. As the economic downturn has placed added demands on the use of public funds to stimulate economic activity, conducting negotiations that free up public funds through the reduction of subsidies may become more appealing.

One key practical question is whether the global economic downturn could cast the long-stalled Doha Round of multilateral negotiations in a new light. Some observers believe that some WTO members may reevaluate the basis for their opposition to some version of the agreement proposed in July 2008 based on today's radically different economic environment. This is, in part, due to the fact that shrinking trade flows have highlighted the importance of open markets for economic development among a broad group of countries, and in the process, increased the value of concessions left on the negotiating table last year. This group includes the export-dependent countries in Asia countries and India. Other observers think that the kind of political leadership that is necessary to push trade liberalization will be in short supply and difficult to secure in a

[60] Michael Pettis, "This Is Not the Time to Attack China," *Financial Times,* February 18, 2009.

[61] It may be hard for the United States to induce China to appreciate its currency while inducing it also to buy U.S. debt since China's undervalued currency is the chief reason why China has to buy that debt.

time of a global recession and increased protectionist pressures. Moreover, the U.S. business community is not enthusiastic about the package of market opening concessions that was proposed last July, thus providing little stakeholder support in the United States for an effort to reach a partial Doha agreement.

## Author Contact Information

Raymond J. Ahearn
Specialist in International Trade and Finance
rahearn@crs.loc.gov, 7-7629

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