EFFECTIVE CRISIS RESPONSE AND OPENNESS: IMPLICATIONS FOR THE TRADING SYSTEM

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Effective Crisis Response and Openness: Implications for the Trading System

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Foreword

The world is just beginning to come out of the most severe global economic crisis since the Great Depression of the 1930s. For the first time since World War II, world GDP is expected to decline in 2009, and growth in developing countries is expected to fall to 1.2% from 5.9% in 2008. Trade has declined as well: global trade volumes are expected to fall by some 10% in 2009; the worst fall in trade since the 1930s. Governments have responded to the crisis with policies to support economic activity and employment. Efforts have been made to coordinate these policy responses, in particular to maintain an open trade regime. The systemic risks of a resort to protectionist policies are generally recognized by world leaders: at the G20 Summits in Washington, London and Pittsburgh, they committed to refrain from raising new barriers and to minimize any negative impact on trade and investment of domestic policy responses to the crisis.

In the spring of 2009, in the middle of the crisis, Simon Evenett, Co-Director of the CEPR trade programme, and Bernard Hoekman, Director of the World Bank's International Trade Department, brought together researchers and trade policy practitioners to assess the cross-border impact of policy responses to the crisis. Their verdict? "So far so good": to date we have not observed large scale increases in the level of discrimination against foreign suppliers of goods and services by major trading states.

There are, however, reasons for continued concern. Even the most optimistic forecasts for economic recovery imply substantial increases in unemployment in the major trading powers in 2010. The protectionist temptation will almost surely intensify before it abates, and a significant use of trade-distorting policy by a major jurisdiction could set off unwelcome domino effects.

Continued vigilance is necessary. A key aspect of this vigilance is Global Trade Alert (www.globaltradealert.org), supported by the World Bank and other donors, and coordinated by CEPR. Global Trade Alert provides real-time information on state measures taken during the current global downturn that are likely to affect foreign commerce. It goes beyond other monitoring initiatives, by identifying the trading partners likely to be harmed by these measures and by encouraging third parties to submit measures for scrutiny. Timely and comprehensive data on policies affecting trade and investment around the world is a public good that has been underprovided by the community of nations. We hope that one result of the crisis will be that a more concerted effort be made to improve the transparency of trade-related policies, including in areas such as public procurement and subsidy programs.

We are delighted to have sponsored the Brussels conference and are grateful to Simon, Bernard and Olivier Cattaneo for their hard work in organizing it, and to the DFID-supported Global Trade and Financial Architecture project for co-financing. More meetings like it will be needed in the future. These meetings – along with Global Trade Alert – will help provide the information needed to ensure that policy responses to the crisis do not beggar us all.

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1

Effective Crisis Response and Openness: Implications for the Trading System

SIMON J. EVENETT, BERNARD M. HOEKMAN
AND OLIVIER CATTANEO

1. THE CONTEXT

The world has now faced the most severe global economic crisis since the Great Depression of the 1930s. For the first time since World War II, in its projections for annual economic performance the World Bank expects world GDP will actually decline (–2.9 percent in 2009) and developing countries' growth will fall to 1.2 percent from 5.9 percent in 2008.[1] Excluding China and India, other developing nations' economies are expected on average to shrink by 1.6 percent. Net private capital flows to developing countries will likely turn negative in 2009 – a more than $800 billion drop from the 2007 peak. The decline in global foreign direct investment (FDI) flows that started in 2008 is expected to deepen and spread to the developing world – with overall inflows projected to fall some 30 percent compared to 2008, the first time FDI has fallen more than 10 percent in a year since 1986. The value of remittances, perhaps the most stable source of external financing for developing countries, is expected to drop by 7 percent this year.

International trade is no exception. Global trade volumes are expected to decline by some 10 percent in 2009; the worst decline in trade since the 1930s. While all regions in the world are severely affected, the impact of the decline is stronger in countries that are highly dependent on trade with the developed countries as demand has contracted the most in those economies. For example, in Cambodia, which relies heavily on tourism and exports of garments to the United States, growth fell from 10.2 percent in 2007 to 6.7 percent in 2008 and the economy is expected to decline by 1 percent in 2009.

Governments have responded to the crisis with many initiatives, some of which have implications for the openness of national economies to global markets. The

[1] All data reported are from World Bank, *Global Development Finance, 2009*.

most prominent of these initiatives – such as large fiscal stimulus packages and the far-reaching monetary easing by central banks – have effects on trading partners and thus create international spillovers. While the primary objectives have been to support demand and thus economic activity and employment, recognition of cross-border spillovers has led to calls for international cooperation and to refrain from beggar-thy-neighbour measures

Arguably these calls have been heard in the policymaking community. Efforts have been made to coordinate policy responses, through the G20 and other fora, including in the area of international commerce. It has been acknowledged, for example, that maintaining an open trade regime is an important part of the path for getting out of the crisis. At the Pittsburgh Summit on 24-5 September 2009, the G20 countries reaffirmed earlier commitments[2] to refrain from raising new barriers and to minimise any negative impact on trade and investment of domestic policy responses to the crisis (see Box 1). This commitment recognises the importance of not taking measures that discriminate against and between foreign providers of goods and services, so disrupting further the commercial playing field.

Failures to cooperate in the past — most notably in the 1930s — help to account for the willingness of governments in the darkest days of 2008 and 2009 to couple vigorous domestic responses with public declarations of international collaboration. Indeed, it would seem that the systemic risks of a significant resort to protectionist policies are generally recognised by world leaders. The 1930s, as well as the more recent extensive resort to protectionism during the early 1980s recession – in the form of 'voluntary' export restraints (VERs) for cars and quotas on textiles and steel – illustrate that if some major countries put in place measures to close domestic markets, the risk of others following is high. As recovery becomes an ever greater prospect in late 2009, and hopefully takes hold, the question arises as to whether current, primarily non-binding inter-governmental cooperation will be sustained. Exports have rebounded substantially from the low point that was observed in the winter of 2009 (Figure 1). This does not mean the trading system is out of the woods, however. To the contrary – the widening gap between trade and job recovery may well become an additional source of stress for inter-governmental cooperation. As trade recovers and imports into markets expand, with job growth lagging, pressure for protectionist measures may increase rather than decrease.

The development of promising cross-border collaborative modalities is only one aspect in the relationship between openness to international commerce and national responses to the sharp global economic downturn and its consequences, such as rising unemployment. In the interests of balance one might also enquire as to whether and to what extent existing binding international trade accords have prevented governments from taking particularly useful policy instruments during the crisis. The need for 'flexibilities' and 'policy space' has been a prominent feature of deliberations in the international trade arena. The crisis offers

[2] Made in April 2009 London summit and the November 2008 Washington DC summit.

AN OPEN GLOBAL ECONOMY

48. Continuing the revival in world trade and investment is essential to restoring global growth. It is imperative we stand together to fight against protectionism. We welcome the swift implementation of the $250 billion trade finance initiative. We will keep markets open and free and reaffirm the commitments made in Washington and London: to refrain from raising barriers or imposing new barriers to investment or to trade in goods and services, imposing new export restrictions or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports and commit to rectify such measures as they arise. We will minimize any negative impact on trade and investment of our domestic policy actions, including fiscal policy and action to support the financial sector. We will not retreat into financial protectionism, particularly measures that constrain worldwide capital flows, especially to developing countries. We will notify promptly the WTO of any relevant trade measures. We welcome the latest joint report from the WTO, OECD, IMF, and United Nations Conference on Trade and Development (UNCTAD) and ask them to continue to monitor the situation within their respective mandates, reporting publicly on these commitments on a quarterly basis.

49. We remain committed to further trade liberalization. We are determined to seek an ambitious and balanced conclusion to the Doha Development Round in 2010, consistent with its mandate, based on the progress already made, including with regard to modalities. We understand the need for countries to directly engage with each other, within the WTO bearing in mind the centrality of the multilateral process, in order to evaluate and close the remaining gaps. We note that in order to conclude the negotiations in 2010, closing those gaps should proceed as quickly as possible. We ask our ministers to take stock of the situation no later than early 2010, taking into account the results of the work program agreed to in Geneva following the Delhi Ministerial, and seek progress on Agriculture, Non-Agricultural Market Access, as well as Services, Rules, Trade Facilitation and all other remaining issues. We will remain engaged and review the progress of the negotiations at our next meeting.

Box 1.1. *Paragraphs 48 and 49 of the Pittsburgh Summit Communiqué, 25 September 2009.*

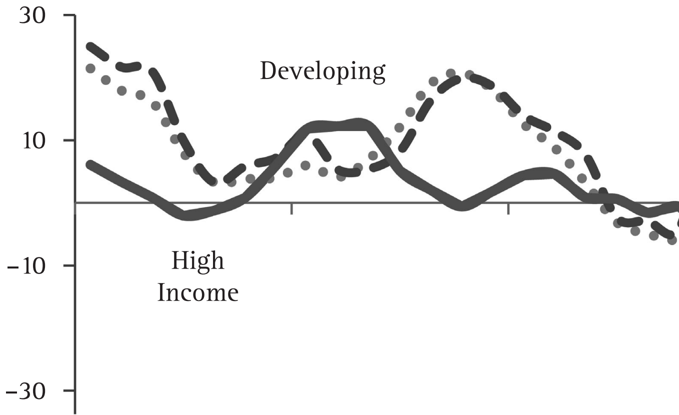

Figure 1.1: *Export volumes, seasonally adjusted, annual percentage change (rolling quarterly average over previous quarter)*

Source: World Bank.

another prism through which to view the costs and benefits of constraints on government behaviour that arise from binding trade accords.

The purpose of this book is to examine the various ways in which the existing manifestations of openness, including binding international accords, have constrained or enhanced the options available to national policymakers during the crisis and influenced the degree, and potentially even the effectiveness, of cross-border cooperation. By examining state responses during the crisis in a number of distinct policy domains, this approach may shed light on potential complementarities and tensions as governments seek to tackle sharp national recessions while being mindful of the growing role that the international dimension has played in influencing national economies in an era of globalisation. In principle, such an examination may reveal that some permutations of national policy choices and international (trade and other) obligations offer greater potential than others, in turn providing information on the possible scope for both domestic reforms and the global trade architecture.

2. WHAT WE HAVE OBSERVED SO FAR

This volume comprises a set of papers presented at a joint World Bank-CEPR conference in May 2009 that assessed the prevalence and cross-border effects of the different policy responses put in place by governments to

the crisis.[3] The conclusion that is suggested is 'so far so good', or to paraphrase Josling and Tangermann in their contribution on agricultural trade policy, so far the protectionist 'dog did not bark'. Although there is much heterogeneity in terms of policy responses, and a growing number of countries have put in place some protectionist measures, to date we have observed very few large-scale increases in the level of discrimination against foreign suppliers of goods and services by major trading states. Indeed some countries, including Mexico, have responded by reducing tariffs and other barriers to trade. Data compiled by the Global Trade Alert indicate that only four nations have to date taken trade policy actions that have affected 25 percent or more of all tariff lines (Evenett, 2009a,b).[4]

A stylised fact that is suggested by the evidence to date and the analyses in the papers included in this volume is that where multilateral disciplines exist, recourse to protectionism has been limited. Some countries have utilised the 'policy space' they have to raise tariffs, but projections – based on past behaviour – are that any such increases are likely to remain limited: Olarreaga and others (Chapter 6) predict increases in 2009 of perhaps 8 percent. In the area of agriculture, Josling and Tangermann (Chapter 17) stress that reactions to the crisis have been relatively muted, and good news (tariff reductions, removal of import bans and export taxes) coincides with bad news (tariff increases, reactivation of export subsidies). In a sector that in the 1970s and 1980s became a bastion of protectionism, textiles and apparel, Frederick and Gereffi (Chapter 18) argue that policy remains very open. Another illustration of this stylised fact is that countries that are not WTO members are among those that have made the most intensive use of measures to restrict trade and investment – for example, Algeria and Russia.

Insofar as protectionist actions are being pursued, many are taking the form of measures permitted by the WTO, especially antidumping and (selective) safeguard actions. While such measures are discriminatory and clearly inconsistent with the letter (and spirit) of the G20 declaration, they are relatively transparent and are constrained by multilateral rules. Indeed, these types of instruments are often described as 'safety valves' that need to be included in trade agreements in order to give governments the assurance that in times of need – as is the case today – they will be able to re-impose a certain level of protection if this is needed for political purposes. While the use of trade policy is second-best – fiscal and monetary policy is more effective and efficient – using instruments of contingent protection to manage pressures for restricting imports in specific sectors can be superior to a government having recourse to nontariff barriers (such as VERs in 1980s). In his analysis of the use of these WTO 'trade remedies' Bown (Chapter 7) notes a sharp increase in the use of antidumping, safeguards, and countervailing

[3] The conference was financed in part by the *Global Trade and Financial Architecture* project, an initiative that is supported by the United Kingdom's Department for International Development.

[4] The *Global Trade Alert* is an independent online service that was set up in 2009 to monitor and increase information on the use and incidence of trade-related policy responses to the crisis. The service is managed by CEPR and can be accessed at www.globaltradealert.org. See Evenett (2009a).

duties, including by almost all the G20 countries. These actions increasingly affect 'South-South' trade, and often target exports from China. However, the amount of imports targeted by these measures thus far remains relatively small: less than half of one percent of the total merchandise imports of G20 countries. The number of measures taken is still below what it was only a few years ago, suggesting that with the exception of a small number of countries – such as India – the overall use of these instruments remains limited.

More recent data (Bown, 2009) suggests that the cumulative number of new requests for protection through trade remedy instruments in the first three quarters of 2009 was 30 percent higher than the number of such requests in the first three quarters of 2008. Although investigations have been expanding rapidly, as of the time of writing the number of final measures imposed has not shown an upward spike; indeed, the share of investigations launched that result in the imposition of final measures declined in the last few quarters of 2009 relative to the historical average observed in recent years. A possible explanation is the existence of WTO rules and criteria, in particular the need to show that domestic industry has been injured by imports, which was a rather stringent test given that trade was falling in much of 2009 (Figure 1). The rapid recovery of trade and imports at the end of 2009 might make the injury-cum-causation tests easier to satisfy, resulting in a reversal of this trend.

A second, and related stylised fact emerging from the papers is that where no multilateral disciplines exist, or where they are weak and limited in coverage, countries have been less able to resist protectionist pressures. The reintroduction of export subsidies by the United States and the European Communities (EC) are high-profile examples of this point; high profile precisely because these subsidies are thought to have harmed many developing countries' commercial interests in the past and have received considerable attention in the Doha Development Agenda (DDA). According to www.globaltradealert.org 80 jurisdictions export the commodities for which the United States has reintroduced export subsidies.[5] The comparable number of affected exporting jurisdictions for the EC's export subsidies was 41.[6]

In his paper, Claessens (Chapter 15) stresses that the absence of adequate multilateral disciplines and mechanisms for cooperation in the area of financial services gave rise to nationalist solutions, distorted resource allocation decisions, and undermined conditions of competition. Similarly, the lack of multilateral disciplines on the movement of natural persons providing services implies that countries are free to redefine the rules of the game unilaterally and (re-)introduce barriers to the local employment of foreign professionals. Malaysia, the United States, and the United Kingdom did just that in the past 12 months.[7] The absence

[5] See http://www.globaltradealert.org/measure/united-states-america-dairy-export-incentive-program.

[6] See http://www.globaltradealert.org/measure/ec-reintroduction-export-refunds-milk-butter-and-butteroil

[7] See the reports on these measures on www.globaltradealert.org the CEPR-led portal for online monitoring of trade-related measures taken during the current global economic downturn.

of any disciplines in the WTO on measures that affect the export of services implies that source countries are free to take actions that have the effect of raising the costs and (or) reducing the flow of financial services.

In his paper on stimulus packages and public procurement, Evenett (Chapter 9) notes that WTO disciplines in this area have limited coverage and that local (subnational, municipal) governments may be free to require that funds be spent on domestic firms' raw materials, parts and components. A number of examples of explicit discrimination can be found in the implementing regulations of the *American Recovery and Reinvestment Act* at the state and local level. Similar provisions[8] have been adopted or proposed in Australia by New South Wales, Afghanistan, Brazil, Canada, China, France, Indonesia, Kazakhstan, Korea, Paraguay, Spain, South Africa, and Taiwan (China) – few of which are bound by the relevant WTO disciplines on procurement, because they have not signed the *Agreement on Government Procurement*.[9]

The policies in these areas are potential examples of so-called 'murky' protectionism (Baldwin and Evenett, 2009), where damage to foreign commercial interests is the consequence of the non-transparent application of discretion given to regulators and line ministries. This type of protectionism is at first cut difficult to identify, and harder to quantify. An example is provided by the actions taken to support automobile producers in Europe and elsewhere, most prominently the Opel saga of summer and late 2009). All too often, the devil is in the details of implementation rather than the umbrella legislation. This suggests that there is an urgent need to monitor closely what all government bodies do, not just those central entities that are subject to international trade disciplines. In his contribution to this volume, Jenny (Chapter 13) argues for a systematic assessment of the impact on competition of all the policy responses to the crisis. This is particularly needed for those state policies which are promoted as serving some unobjectionable goal, but where the implementation details suggest that competition and market forces are unduly distorted.

Beyond this, given that countries appear to be abiding by WTO commitments where these apply, the problem is that there are no multilateral disciplines in key areas (financial sector; fiscal stimuli, subsidies) or countries have not committed themselves to abide by existing rules (government procurement, services trade). Ultimately this suggests a priority for governments is to (re-)engage in negotiations to establish such disciplines. Indeed, the resort to discriminatory state policies during this sharp global economic downturn could – and should – help define the commercial policy priorities for governments in the early twenty-first century.

[8] As of November 2009, the GTA database contains reports on 29 public procurement-related state measures.

[9] This Agreement is one of two agreements in the WTO where participation is voluntary. Almost all developing countries and some OECD countries have not signed the procurement agreement. The reason a separate agreement is needed in the first place is that the WTO does not cover public procurement that is, the basic non-discrimination rules (MFN and national treatment) do not apply to government purchases of goods and services. See Hoekman and Kostecki (2009) for more detail.

3. FACTORS EXPLAINING THE LIMITED USE OF TRADE POLICY TO DATE

Although many countries have imposed protectionist measures, there has not been much in the way of tit-for-tat retaliation. More generally, a number of factors explain why, so far, protectionism seems to have been contained. As Irwin stresses in his contribution (Chapter 2), the foremost reason that countries have been able to avoid repeating the experience of the 1930s is because of their willingness to rely on expansionary monetary and fiscal policy. In the 1930s these instruments could not be used to the same extent due to the Gold Standard and balanced-budget orthodoxy.

Another important factor is the extent of globalisation of production that has occurred in the last 20 years or so. For many companies (and thus governments) this has changed the incentives to seek protectionist policies. Maintaining an open trade regime is in the interest of firms that are part of global supply chains, as closure would substantially raise costs and undermine competitiveness. This helps to explain why many of the countries that have taken overt protectionist action tend to be less integrated in global supply chains (for example, Algeria, Argentina, Ecuador, India, and Russia). It may also explain why firms have sought bailouts and subsidies rather than tariff increases from their governments. (Plus, tariff increases are not much use to a firm that sells little to the market in which it is operating or where a sharp economic downturn has cut into the customer base substantially. Much better to obtain a direct fiscal transfer – a subsidy – if it is available, rather than wait for a tariff to reshuffle what customers remain from foreign goods to goods produced domestically.)[10]

A third possible factor is the WTO, as well as so-called deep regional integration agreements, such as the European Union, and the extensive web of bilateral investment treaties. There are now binding international disciplines that go some way to deter countries from violating the national treatment principle. As mentioned above there is a negative correlation between the use of restrictive trade policy and WTO disciplines in the relevant areas. Should the number of WTO and investment disputes increase substantially as the economic recovery beckons, then this finding may need to be nuanced. Still, it would demonstrate that governments are resorting to official dispute-settlement procedures and not taking matters immediately into their own hands.

There is also a willingness to build on and use the multilateral trading system as a tool to fight the crisis. The ability by the G20 to pledge over $250 billion over several years to boost trade finance is an example. Another is the engagement by the WTO to monitor actively and publically the use of policies by its members, increasing transparency and stimulating peer pressure with regard to the design and implementation of potentially harmful policy responses to the crisis (WTO, 2009).

[10] Section 4 of Evenett (2009b) discusses these considerations in greater detail.

4. WORRISOME TRENDS CALL FOR INCREASED VIGILANCE, NOW AND IN THE FUTURE

The monitoring work of the WTO and the Global Trade Alert has revealed some worrisome trends that could strengthen depending on economic developments in the course of 2010. The crisis has put governments under severe pressure to assist domestic industries and support employment. It is too early to know whether a "double dip" economic recession will occur. Although the signs are that the crisis has bottomed out, the prospects are for a slow recovery with unemployment forecast to stay high in several leading trading nations. This implies that governments will remain under pressure for some time to take actions to support local economic activity.

A number of considerations call for increased vigilance over the next months:

1. In some leading jurisdictions at the end of 2009 a significant portion of fiscal stimulus packages remain to be spent, and implementation may produce further discrimination. If so, as trading partners realise the growing level of discrimination, the temptation to 'retaliate' may grow.
2. Even the most optimistic forecasts for economic recovery imply high levels of unemployment in the major trading powers in 2010. Rising unemployment has long been associated with government resort to protectionist measures. The protectionist temptation will almost surely intensify before it abates.
3. Many governments now have little margin for manoeuvre in fiscal and monetary policy, and in the event that the recession persists, they could turn to trade and industrial policies as a stop-gap resort.
4. A significant increase in the use of trade-distorting policy by a major jurisdiction could set off unwelcome domino effects, not unlike those witnessed for auto subsidies, dairy export subsidies, and procurement nationalism in the course of 2009. This concern applies as well to the use of border instruments for apparently benign purposes, such as mitigating climate change. Currency pegs and exchange rates could become a flashpoint too.
5. While there is clear need for continued vigilance in the coming months, the crisis has also revealed weaknesses in the existing transparency and notification mechanisms. Recent monitoring efforts by the WTO and the GTA have shed a new light on the limited extent of information on discriminatory application of policies. There has been a long-standing gap between implementation of commitments relating to transparency of policies – e.g., notifications on the use of subsidies to the WTO, which appear to be honoured more in the breach than the observance. This lacuna has received considerable attention in the context of the crisis, and has generated several specific proposals by WTO members to address some of the gaps – most notably by India, in a communication to the WTO supported by 17 other members (India, 2009). This suggests the crisis may have a silver lining for the trading system – it may revive interest in, and support for, allocating both the financial resources and the political commitment that are needed to enhance transparency of – and accountability for – policies affecting international trade and investment.

5. POLICY IMPLICATIONS AND RECOMMENDATIONS

Resisting the protectionist temptation has not been a matter of luck or chance—nor will it be in the future. During 2008 and 2009 almost every government has sought to tackle typically sharp national economic downturns by using tools that do not call into question their commitment to open borders. Still, more could be done to enhance the contribution of trade rules and this will require more than declarations of good intent. Concrete steps toward reinforcing the global trade system are needed and are outlined below.

The crisis has revealed that rules matter: for many, WTO disciplines appear to have played a positive role in constraining recourse to protectionism. This makes rapid conclusion of the Doha Round important. The responses to the crisis clearly illustrate that a multilateral trade negotiation should not be assessed only on the basis of how many new market access opportunities it generates. This has been the metric used by many lobbies, analysts and the press, as well as some key negotiators. As argued at greater length by Hoekman, Martin and Mattoo (2009), this is misconceived. The primary role of the WTO is to set the rules of the game and to lock-in the policies of members.

As the crisis continues, the opportunity cost of inaction on Doha rises. A common conclusion from the contributors to this volume is the need to conclude the Doha round rapidly. This would limit the ability of governments to increase tariffs or agricultural subsidies in the future, send a strong signal of the international community's commitment to keep trade and investment flowing, and help countries resist pressures for protection when they begin to unwind their current expansionary policies. The value of 'what's on the table' has increased as a result of the crisis.

Concluding Doha is also important as critical policy matters outside the Doha Development Agenda need to be addressed. The lack of agreement on the Doha Round is crowding out the prospects for cooperating on initiatives that address large cross-border knock-on effects. Climate change is the most obvious example, where there is an urgent need for governments to consider the implications for the trading system of concerted action to reduce carbon emissions and green house gas emissions. Finishing the Doha Round is probably a realistic precondition for addressing some of the weaknesses in the global trade and financial architecture that the crisis has revealed.

Government responses to the current global economic downturn have other implications for the multilateral trading system. First, the areas where 'murky' protectionism has emerged suggest that there is a need to expand the scope of multilateral cooperation. Potential areas for negotiating rules of the game include competition policy, public procurement, other non-tariff barriers, service-sector regulation, and subsidies, including investment incentives. 'Murky' protectionism is just one facet of a fundamental mismatch between trade rules that were designed in the early 1990s or earlier and contemporary regulatory priorities as they relate to the global trade and financial system.[11] The absence of international rules in these areas allows discrimination to be pursued with impunity.

[11] It being recalled that the prevailing multilateral trade accords were negotiated based on an agenda set in 1986! Those born in that year are now old enough to drive cars and vote.

Second, 'murky' protectionism may not be just a crisis phenomenon. Ongoing monitoring work and related analysis has revealed that very little is known about the distribution of local government procurement and what share of purchases is allocated to local firms. The same is true of subsidies and many non-tariff policies. In part this is a reflection of the absence of multilateral disciplines, so that there is no need to report or to collect the requisite data. In part it is a reflection of the fact that WTO members are simply not living up to their existing commitments in the area of notifications and transparency.

At a minimum, recent monitoring exercises suggest that the WTO notification and review mechanisms should be strengthened. It is important to increase monitoring and public reporting efforts, so that government measures that could negatively affect trade and investment – whether compatible or not with WTO rules – can be identified more systematically and at an earlier stage. Transparency is one of the best defences against protectionism.[12] Predictability and security of transactions remain the main drivers of global trade and investment.

The papers by Steenblik (on 'green protectionism' – Chapter 14) and Borchert and Mattoo (on services – Chapter 19) illustrate that, whether or not policies are subject to disciplines, it is important that there be regular monitoring of government policies that may have major cross-border spillovers and analysis of their impact and incidence. In some policy areas there is much information – see for example, Weber and Wyplosz's observations in their paper on exchange rate policies (Chapter 10) – but in others we are very much in the dark. Beyond *ad hoc* monitoring mechanisms, it is necessary to strengthen institutional notification, data collection and review mechanisms. As noted previously, the very incomplete extant information on the magnitude of subsidies, the degree of competition, the pattern of public procurement, the use of non-tariff measures, and the incidence of services trade policies implies that analysts and policymakers are limited to looking "under the lamppost" and may not be aware of how they are being affected by the policies of trading partners. Rectifying this situation will require the allocation of additional dedicated resources, as well as political support and leadership to collect, compile, and disseminate the information.

While there has been much improvement in the collection and reporting of data on import tariffs, and the development of software that can be used to analyze these data, little progress has been made in the collection of information on non-tariff measures (NTMs). The WTO does not systematically collect data on NTMs, relying instead on notifications of qualitative information by members and periodic Trade Policy Reviews of members. There is also no systematic collection of data on policies affecting trade in services. Efforts by institutions such as the International Trade Centre, UNCTAD and the World Bank to collect data on NTMs and services are funded irregularly and have not been systematic, com-

[12] The desire to provide high-quality information that could be used to add peer pressure on governments was an important rationale for the CEPR to launch *Global Trade Alert*.

prehensive and sustained.[13] Filling the numerous gaps in the data will require a concerted effort and collaboration between the different agencies with expertise in this area, both multilateral and regional (Hoekman and Newfarmer, 2009).

Third, while many government policy responses to the crisis may be temporary, the effects of 'buy national' or 'buy local' could prove enduring if they result in emulation. It is noteworthy for example that some of the countries that are engaging in 'buy national' policies are among those that have been most interested in seeing developing countries accede to the Agreement on Government Procurement. The signal that is being sent may have long-term negative consequences for the realisation of this objective. The same is true of actions by governments to restrict access to local services markets for foreign nationals, especially those countries where the demographics point to a greater need for foreign workers in the future. The longer-term costs of short-term policies may be significant if it results in future suppliers (trading partners) requiring a 'risk premium' to supply services. It was amidst strained circumstances, in 1943–4, that the architecture of the post-war world economic order was established. There should be no delay in taking action to begin to remove discriminatory and trade-distortive measures that have been adopted to respond to the crisis.

Finally, it would be short-sighted to yield ground to protectionism. The crisis is stimulating innovation by firms and in so doing creating new trade opportunities. As the recovery accelerates the more open economies will be better placed to benefit from the increase in demand. From this perspective, it is particularly important that efforts continue to focus on enhancing the competitiveness of firms and farmers in low-income countries by, *inter alia*, actions to lower trade and transport costs. In general, sustaining efforts to expand the delivery of 'aid for trade' and achieving the commitments that were made in this regard at the 2005 WTO Ministerial Meeting in Hong Kong should be a priority, as they will help developing countries to benefit more from the recovery.

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[13] An important corollary of the status quo is that many developing countries, already at a disadvantage because of limited knowledge about extant data sets, imperfect access, and constrained technical capacities do not have access to the information they need on prevailing trade policies (both their own and those of trading partners) and their effects. Better data and tools are a critical input into helping policymakers in developing countries improve economic policies for trade competitiveness – without data on the effects of policies, on market access barriers abroad, on market entry hurdles (e.g., standards, rules of origin), and on new market opportunities for existing or new products in which a country has a comparative advantage the benefits of trade will not be maximized.

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2

Avoiding 1930s-Style Protectionism: Lessons for Today

DOUGLAS A. IRWIN

1. INTRODUCTION

A statement released by the G20 leaders on 2 April 2009 emphatically noted: "We will not repeat the historic mistakes of protectionism of previous eras". To what historic mistakes of previous eras were the leaders referring?

Almost unquestionably, the reference was to the Great Depression of the 1930s. Indeed, the world's current economic and financial crisis – complete with plummeting stock markets, collapsing world trade, sharply rising unemployment rates, and even the threat of deflation – has prompted many comparisons to the depression. The 1929–32 period, during which economic activity collapsed around the world was marked by a severe outbreak of protectionism and a breakdown of the world trading system. The rise in trade barriers is believed to have intensified the depression and to have hindered the economic recovery. And the trade barriers imposed under the 'emergency' conditions of the day remained in place for a period that stretched into decades, blocking the expansion of world trade, even though the original justification for the barriers had long since passed.

To avoid repeating the calamity of the 1930s, it is necessary to understand precisely what happened to the world trading system during that terrible decade. This brief paper presents an account of the deterioration in trade relations at that time and examines the similarities and dissimilarities between the situation then and today. It concludes that conditions are different enough today such that a 1930s-style resort to protectionism is unnecessary and unlikely. However, there are other historical parallels that present a danger, such as 1970s-style conflict over subsidies that supported industries with excess capacity and had adverse spillover effects across economies.

2. THE TRADE POLICY BREAKDOWN IN THE 1930s

Almost everyone with a rudimentary understanding of the 1930s knows that the period was marked by greater protectionism – the infamous Smoot-Hawley tariff in the United States stands out in the public imagination – and collapsing trade. But was there any rhyme or reason to the mad scramble to block imports?

Most accounts, such as Kindleberger (1986), suggest that all countries succumbed to the pressure to close markets to foreign goods. In fact, there was a logical progression to events as they unfolded in the early 1930s and there was a high degree of variation in the extent to which countries limited trade.

To understand the breakdown in the world economy, it is essential to appreciate that the international monetary system was based on the gold standard. This regime of fixed exchange rates linked countries to one another, and ensured that shocks to one country would be quickly transmitted to others. In addition, the gold standard tied the hands of monetary authorities, who were obligated to maintain the value of their currency in terms of its gold parity. The loss of monetary autonomy meant that the policymakers lacked an important policy instrument (an independent monetary policy) to help adjust to any such shocks.[1]

While economic historians continue to debate the origins of the depression, many have argued that the decision by the Federal Reserve Board to tighten credit in early 1928 was a turning point.[2] By raising interest rates, the United States began to attract gold from other countries, forcing them to raise interest rates and tighten credit conditions as well. The United States, along with many other countries around the world, reached a business cycle peak in mid-1929, after which economic activity began to slow. While the US stock market crash in October 1929 was a disturbing development, there was no reason to expect that the slide into the recession would necessarily lead to the Great Depression that followed.

It is commonly believed that the United States led the movement toward greater protectionism when President Herbert Hoover signed the Smoot-Hawley Tariff Act in June 1930. This tariff legislation, which Congress began considering in late 1928, was originally designed to insulate farmers from low agricultural prices, but was expanded to include higher duties on manufactured goods as well. The higher tariff was not a response to the depression – the duties in the bill were largely set when the House of Representatives passed the bill in May 1929, a few months before the business cycle peak – although the deteriorating economic outlook in late 1929 and early 1930 probably aided its passage in the Senate.

The Smoot-Hawley tariff raised import duties by about 20 percent, increasing the average tariff on dutiable imports from about 40 percent to 47 percent.[3] Yet the impact of the Smoot-Hawley tariff on world trade was limited. Around this time, about two-thirds of US imports entered the country duty free; indeed, most Latin American exports were unaffected by the duties. European manufactured goods were hit by the higher tariffs, but only six percent of Europe's exports were destined for the US market. Declining US demand for all goods was a far greater problem for most foreign exporters.

[1] Eichengreen (1992) is the classic study of the relationship between the gold standard and the Great Depression.

[2] See Hamilton (1987).

[3] The average tariff on dutiable imports subsequently rose to nearly 60 percent, but this occurred because price deflation increased the *ad valorem* equivalent of the many specific duties in the tariff code. This increase in duties would have happened even if the bill had not been enacted. See Irwin (1998).

Still, the US action provoked intense bitterness and resentment abroad. Here was the world's largest creditor nation, with a substantial trade surplus, restricting the trade of other countries that were trying to pay off their World War I debts. Here was a country that failed to join the League of Nations now undermining that body's efforts to coordinate a tariff truce among countries to stop any movement toward greater protectionism.

Many countries protested the enactment of the Smoot-Hawley tariff, and some even retaliated by imposing restrictions on US exports. Certainly other countries saw America's move as an excuse to raise their own tariffs. As the League of Nations (1932, p.193) put it at the time: "The Hawley-Smoot tariff in the United States was the signal for an outburst of tariff-making activity in other countries, partly at least by way of reprisals. Extensive increases in duties were made almost immediately by Canada, Cuba, Mexico, France, Italy, [and] Spain." The tariff had the biggest impact on Canada, America's largest trading partner. The tariff led to the electoral defeat of the pro-American Liberal government in July 1930 and the election of the pro-British Conservative Party. The Conservatives retaliated by imposing higher duties against US goods and began thinking about a preferential trade agreement with Britain.[4]

Still, if one were to ask, whether the Smoot-Hawley tariff led to the collapse of the world trading system by the end of 1930 or early 1931, the answer would have to be 'no'. While trade relations deteriorated and the League's efforts at a 'tariff truce' came to naught, the system of world trade was disrupted but not destroyed.

The series of events that really began to undermine the trading system started with the failure of Creditanstalt, Austria's largest bank, in June 1931. This failure contributed to a financial panic that spread to neighbouring countries and around the world. In particular, the failure led to a financial crisis in Germany, as depositors began massive withdrawals of funds and demanding gold in exchange for marks. This prompted Germany to impose strict controls on foreign exchange transactions that impeded trade and capital flows alike. Just days after Germany imposed exchange controls, Hungary and Chile followed suit as well to stem the loss of gold and foreign exchange reserves.

Financial pressure quickly spread to Britain. After attempts to support the pound on foreign exchange markets, Britain relented to the financial pressure. Unlike Germany, Britain did not opt for exchange controls. Rather, Britain abandoned the gold standard in September 1931 and allowed the pound to depreciate against other currencies on the foreign exchange market. Other countries whose currency was tied to the pound sterling, including Denmark, Finland, India, Norway, and Sweden, also allowed their currencies to depreciate relative to gold; Japan followed in December 1931.

While there were sound domestic economic reasons for Britain's action, it led to the breakdown of international trade relations. The British action triggered a defensive response by countries that remained on the gold standard. A month after the British devaluation, France imposed a 15 percent surcharge on British

[4] See McDonald, O'Brien, and Callahan (1997).

goods to offset the depreciation of sterling and began to impose restrictive import quotas. In early 1932, the Netherlands, which traditionally had a policy of free trade, increased duties by 25 percent, partly to offset the competitive advantage gained by sterling area producers.

The British move also put other countries under financial pressure and forced them to impose exchange controls. In September–October 1931, the following countries implemented exchange controls: Uruguay, Colombia, Greece, Czechoslovakia, Iceland, Bolivia, Yugoslavia, Austria, Argentina, Belgium, Norway, and Denmark (Gordon 1941, 54–55). Exchange controls – which restricted the use of foreign exchange, not only to prevent capital flight, but to reduce spending on imports as well – were among the most restrictive trade practices of the early 1930s.[5]

Britain followed the depreciation of the pound by enacting higher tariffs. In November 1931, Britain enacted the Abnormal Importation Duties Act which gave authorities the discretion to impose higher duties on selected goods. In February 1932, Parliament passed the Import Duties Act which imposed a 10 percent across-the-board tariff along with additional restrictions on selected imports, although goods from the Empire were exempt. The British adoption of protectionist policies marked a great retreat for a country that historically had been a staunch free-trade country at the centre of the world economy. It was also somewhat paradoxical, because John Maynard Keynes and other economists had argued that devaluation and protection were substitutes rather than complements.[6]

The economic crisis of mid- to late-1931, as well as the change in Britain's trade policies, was much more responsible for the deterioration in trade policy around the world than the Smoot-Hawley tariff had been. In its *World Economic Survey 1931/32*, the League of Nations (1932, 289) said that:

> "It is impossible in any brief summary to make anything like a complete statement of all the various devices brought into use to restrict trade. Especially after the abandonment of the gold standard by Great Britain in September 1931, there has been a veritable panic, which has piled new tariffs on old, turned licensing systems into prohibitions, monopolies and contingents; denounced existing commercial agreements; created more and more rigid exchange controls issuing in debt moratoria and paralysing trade; and substituted a slight and temporary framework of clearing agreements for previous existing treaties....There has never before been such a wholesale and widespread retreat from international economic co-operation".

The next year, the League of Nations (1933, 16–17) elaborated on this point:

> "The multiplicity and variety of these emergencyrestrictions [on international trade] after September 1931 is difficult to summarise in a few words.... In the sixteen months after September 1st, 1931, general tariff increases had been imposed in twenty-three countries, in

[5] Wei and Zhang (2007) show that exchange controls today inflict substantial collateral damage on trade.

[6] Keynes advocated import restrictions on the assumption that the gold standard was inviolable. Once Britain went off the gold standard, Keynes disavowed the use of protectionism, clearly viewing import tariffs and devaluation as substitutes. See Eichengreen (1984).

three of them twice during the period – with only one case of a general tariff reduction. Customs duties had been increased on individual items or groups of commodities by fifty countries, in most cases by a successive of enactments which, in several countries, numbers over twenty tariff changes in the sixteen months. Import quotas, prohibitions, licensing systems and similar quantitative restrictions, with even more frequent changes in several important cases, had been imposed by thirty-two countries. Import monopolies, for the most part on grains, were in existence in twelve countries; milling or mixing regulations in sixteen others. Export premiums were being paid in nine, while export duties or prohibitions had been imposed in seventeen. This bare list is utterly inadequate to portray the harassing complexity of the emergency restrictions that were superimposed upon an already fettered world trade after the period of exchange instability was inaugurated by the abandonment of the gold standard by the United Kingdom in September 1931. By the middle of 1932, it was obvious that the international trading mechanism was in real danger of being smashed as completely as the international monetary system had been."

Thus, by 1932, a wide range of controls and restrictions – higher tariffs, new import quotas, controls on foreign exchange transactions – had been imposed on trade around the world. The volume of world trade fell 26 percent between 1929 and 1932, as Figure 2.1 shows. According to Madsen's (2001) calculations, about 45 percent of this decline was due to lower income and about 55 percent due to an increase in tariff and non-tariff barriers to trade. In addition, countries began forming preferential trading areas, most notably the Imperial Preferences of the British Empire. This balkanised trade in exclusive trade blocs and complemented bilateral clearing arrangements as the multilateral pattern of trade and payments was in a shambles.

Eventually, all countries left the gold standard. The United States delinked the dollar from gold in April 1933 and allowed the dollar to depreciate. The remaining gold bloc countries – France, the Netherlands, Belgium, and Switzerland – clung to gold but eventually abandoned the standard in 1936 (1935 in the case of Belgium). The timing of a country's recovery during the depression is intimately linked to when it abandoned the gold standard, because it allowed countries to reduce interest rates and expand the money supply, relieving financial distress and promoting recovery. Britain and the sterling area, which left gold in 1931, experienced a relatively mild recession, whereas the gold bloc countries, which did not leave until 1936, suffered a prolonged economic downturn.[7]

This suggests that the best strategy to have combated the depression would have been a suspension of the gold standard or a coordinated change in the gold parities such that all countries could have pursued monetary reflation, even with fixed exchange rates. Instead, there was no international coordination, countries left the gold standard in a haphazard fashion, and those that did intensified the economic problems faced by those remaining tied to gold.[8] Unfortunately, the world trading system was a casualty of this process.

[7] See Eichengreen and Sachs (1985) and Campo (1990).
[8] Eichengreen (1990) explores the reasons for the lack of policy coordination.

3. UNDERSTANDING THE 1930s BREAKDOWN

How should the breakdown in world trade relations in the early 1930s be interpreted?

Eichengreen and Irwin (2009) argue that the move toward protectionism was intimately related to the real or perceived constraints on macroeconomic policy instruments. Countries that clung to the gold standard were unable to use monetary policy to prevent the slide from recession to depression. In addition, fiscal policy was constrained by the prevailing economic orthodoxy that governments should run balanced budgets even in bad times; hence, there should be fiscal retrenchment in an economic downturn, not a fiscal expansion. Therefore, since many countries ruled out the use of monetary or fiscal policy to address the depression, the turn to protectionism was simply an alternative (albeit inferior) way of reducing capital outflows and the loss of gold and foreign exchange reserves.

In this sense, devaluation, exchange controls, and trade restrictions were substitute policy instruments.[9] Countries that chose to devalue did not need exchange controls or trade protection. Alternatively, countries that could not or would not devalue almost invariably imposed exchange controls or adopted protectionist trade measures. As Eichengreen and Irwin (2009) show, this general pattern holds. Countries that abandoned the gold standard relatively early in the depression, notably Britain and others in 1931, did not increase tariffs very much (Britain notwithstanding). Other countries, such as Germany, were constrained from using devaluation as a policy option. Under the terms of the reparations set after World War I, Germany could not abandon the gold standard. Furthermore, having experienced a massive hyperinflation less than a decade before, the German government did not want to risk monetary instabilitystability.[10] This explains their resort to exchange controls. France and the gold bloc clung to the gold standard because they had difficulty establishing monetary stability after World War I. These countries imposed higher tariffs and import quotas to a much greater extent than others with the onset of the depression.

Under fixed exchange rates, there is an intellectual case for protectionist policies to provide a macroeconomic stimulus in lieu of a devaluation. Yet, like the optimal tariff argument, trade restrictions are a 'beggar thy neighbour' policy that only brings a stimulus if implemented unilaterally and without foreign retaliation. When every country adopts such a policy it destroys trade and with it any potential stimulus: the benefits to one country from reducing its imports are offset by a loss in its exports. As the League of Nations (1932, 158) noted:

> "The currency disruptions and trade restrictions which have complicated the course of trade since the latter part of 1931 may serve in some cases to improve or prejudice the relative trading position of individual countries, but their cumulative and combined effect has been greatly to diminish the total value of world trade. Even for those countries whose competi-

[9] As Keynes pointed out at the time, devaluation is equivalent to an import tariff plus an export subsidy. But it is more than that because it allows monetary policy to be used to reduce interest rates and increase domestic demand.

[10] See James (1986).

tive position has been improved by a lowering of export relative to import prices, there is little consolation in securing a somewhat larger share of a constantly diminishing total".[11]

Furthermore, many of the trade controls adopted in the early 1930s were not removed until well after World War II.[12]

4. SIMILARITIES AND DISSIMILARITIES TO TODAY

Without doubt, there will be an increase in protectionist measures during the current economic recession. Many such measures are WTO-legal. The use of antidumping duties is very countercyclical and inevitably rises as economic growth falters. In addition, for most developing countries, bound tariffs are much higher than applied tariffs. If they wanted to do so, these countries could increase their duties on imports without violating WTO commitments. Finally, in areas where WTO agreements are weak, such as government procurement, the temptation to impose 'buy-local' requirements (such as the Buy America provision in the stimulus bill) may prove irresistible.

But is there a risk of a 1930s-style increase in protectionism? Fortunately, the world economy in the 2000s is very different from the world economy in the 1930s. Most of the differences augur well for preventing another outbreak of protectionism.

First, countries today have many more policy instruments for dealing with the current severe recession. Governments are significantly less constrained in terms of using monetary and fiscal policy to address the economic crisis. In the 1930s, governments took no responsibility for propping up financial institutions and were unable to pursue reflationary monetary policies because of the gold standard. Today, expansionary monetary and fiscal policy measures have been used in the United States, the European Union, and elsewhere to offset the recession. While governments may be under political pressure to protect certain producer interests, policymakers are not under the illusion that protectionism can provide a macroeconomic stimulus on par with monetary and fiscal policy.

Second, in the early 1930s, countries imposed higher trade barriers unilaterally without violating any international agreements or anticipating much foreign reaction. Today, WTO agreements restrict the use of such discretionary trade policy. Countries that are tempted to violate WTO agreements can have no illusion that they will avoid swift foreign retaliation if they choose to do so. When a country is certain that its exports will face new impediments abroad if it chooses to impose WTO-inconsistent import restrictions, that country will think twice about restricting imports.

[11] Similarly, Foreman-Peck, Hughes-Hallett, and Ma (2007) conclude: "For all their damage to trade, trade policy instruments were not a powerful means of achieving national targets. Monetary and fiscal policies were far more effective.... The other two instruments – the discount rate and government expenditure – were clearly more potent and more appropriate to the three targets – output, prices, and the current balance – than trade controls".

[12] See Irwin, Mavoridis, and Sykes (2008) for a study of how the GATT grew out of the inter-war trade policy experience.

Third, the share of the workforce in sectors directly affected by international trade – mainly agriculture and manufacturing – is much smaller today than in the 1930s. In the case of the United States, for example, about 44 percent of the labour force was in agriculture, mining, and manufacturing in 1930 and hence might benefit from import restrictions. Today that share is about 14 percent. The service sector of the economy is much more insulated from foreign competition, which means the scope for beneficial expenditure-switching policies is that much less.

Fourth, unlike the early 1930s, foreign investment has transformed the world economy. Leading firms around the world have become so multinational in their production operations and supply chains that they have a vested interest in resisting protectionism. Many industries that faced import competition in the past, such as television and automobiles and semiconductors, have found that international diversification or joint ventures with foreign partners are a more profitable way of coping with global competition than simply stopping goods at the border. Many domestic industries no longer have much of an incentive to ask for import restrictions because foreign rivals now produce in the domestic market, eliminating the benefits of trade barriers for domestic firms. For example, unlike the early 1980s, US automakers are not asking for trade protection because it would not solve any of their problems; they are diversified into other markets with equity stakes in foreign producers, and other foreign firms operate large production facilities in the United States.

While these important differences suggest that a protectionist trade war need not break out like the 1930s, there are other historical episodes that might provide a closer parallel to today. In the early 1970s, however, a series of macroeconomic shocks coincided with an intensification of trade competition due to the rise of Asian producers in Japan, Korea, and Taiwan. These changes required structural changes in several of the US and Western European industries, such as steel, chemicals, automobiles, and footwear. In particular, there was worldwide excess capacity that required some rationalisation. That downsizing process was difficult and costly, requiring plant closures and layoffs, and many governments resisted this trend by using subsidies to prop up domestic producers and maintain the capacity at home. The trade problems caused by the reluctance of countries to reduce capacity allowed trade frictions to grow and trade barriers to proliferate in the 1970s and 1980s.[13] The subsidy code of the Tokyo Round Agreement was a response to the problems of that period, but was largely ineffectual.

Today, with government intervention on behalf of automakers and support for banking and financial services firms, countries may be tempted to resist the need for restructuring. If one country tries to prop up its own firms, thereby imposing costs on similar firms in other countries, the subsidies may lead to counter-subsidies and trade restrictions.

[13] See Strange and Tooze (1981).

5. CONCLUDING REMARKS

This paper explains the greater protectionism in the 1930s as the consequence of the lack of macroeconomic tools to address the Great Depression and halt the deterioration in a country's balance of payments. With more economic policy instruments in play today, the need to resort to trade restrictions should be less of a problem. Yet severe recessions are always dangerous periods for trade policy, and policymakers should remain on guard against measures that have external ramifications and might lead to countervailing policies in other countries.

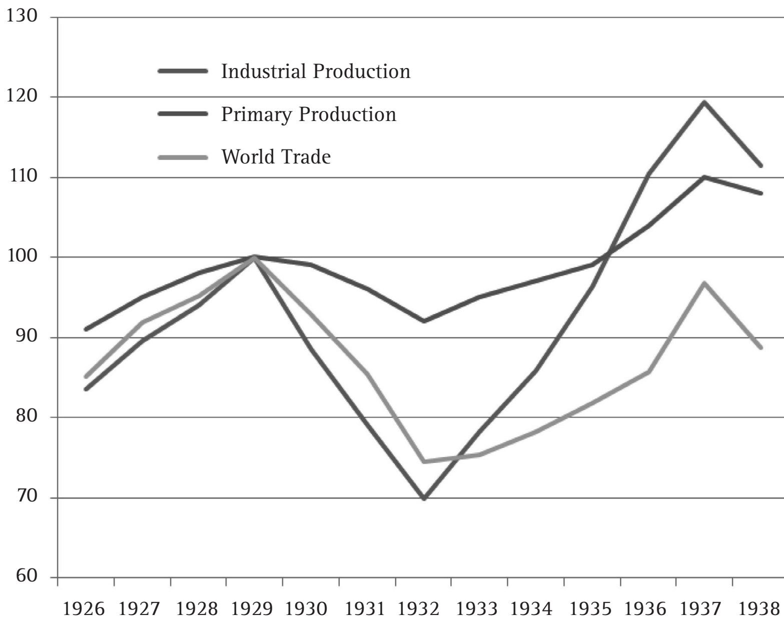

Figure 2.1: *World Trade and World Production, 1926–1938*

Source: League of Nations

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3

A 'Significant Slippage' in Protectionism? Not Yet

PATRICK MESSERLIN

1. INTRODUCTION

In its March Report on the 'financial and economic crisis and trade-related developments, the WTO (2009) used the term 'significant slippage' to qualify changes in protection observed from late 2008 to March 2009. Most of the newspapers in the world translated these terms into 'rise in protectionism'.

This note argues that evoking a rise in protectionism in April 2009 was premature—still is. Disputing this statement may seem futile. It is not. Such a misrepresentation of the situation offers protectionist interests a considerable tactical advantage in the coming months. First, it will make it more difficult for a government to convince its country to liberalise when everybody else is allegedly busy raising protection. Second, as nothing bad will flow from such a 'rise of protection' – for the excellent reason that few additional protectionist measures have been taken so far – protectionist lobbies are in the ideal situation to claim that 'raising protection' does not have the dire consequences that economists predict. Then, they will quickly add that more protection could thus be – and should be – granted more lavishly. Public opinion could only agree.

Such a scenario is not a fantasy. It has already occurred. When, in 1995, negotiators presented farm liberalisation as a result of the Uruguay Round (while it was a mere possibility, indeed still to materialise) many supporters of farm protection used the negotiators' statement as sufficient proof that all the difficulties met by the farmers after 1995 were caused by such a liberalisation, while these problems were due to the highly distorted agricultural policies of industrial countries. It took a full decade to eliminate this perverse twist in public opinion, and to impose a more accurate assessment of the true achievements of the Uruguay Round and of the true causes of the post-1995 problems in agricultural markets.

This note tries to make a cold-minded assessment of the current situation. It relies essentially on the evidence provided by the March Report, using the September Report only when necessary.[1] Both Reports require a careful interpretation

[1] Since March, two follow-up reports have been produced, the latest one in September. These reports do not provide information modifying substantially the views presented in this note. As a result, the note makes reference to the September Report only when needed for updating information.

for two key reasons. First, not all new measures are notified to the WTO. This limit is often seen to create a systematic under-estimate of the level of protection. This is far from certain. Rather, one could reasonably argue that, in the coming year(s), it will be more difficult to hide protectionist measures (because hurt trading partners will cross-notify) than to overlook inadvertently pro-market opening measures (which hurt no one). The second reason is that the WTO Reports allow only for a mere counting of the measures adopted, offering no systematic sense of their economic importance. This note will provide some sense of the most important measures – the only ones that really matter.

2. TRADE-RELATED MEASURES

Table 3.1A summarises the 'trade-related' measures (a term covering the usual range of trade instruments) listed in Annex 1 of the March Report (WTO, pp.28–35 2009). Table 3.1A suggests five lessons.

2.1 One-third of the measures taken have been market-opening

The world press has been silent on the fact that one-third of all these measures listed in the March Report improved market access. First, the March Report lists a notable number of reductions or cuts of import tariffs. Among them, there is the most important change among all the listed trade-related measures – the program of tariff cuts decided by Mexico (the seventh-largest world economy). Strangely, the March Report did not refer to this initiative in its text, but kept the information in the list itself, buried among much more limited measures. It is not surprising that the world newspapers did not highlight it.

Second, the measures listed include many reductions in export taxes. Economic analysis shows that cutting export taxes is equivalent to cutting tariffs, justifying their classification as market-opening measures. This second group of measures is all the more crucial, because it has been mostly taken by large emerging economies, such as China – on a large scale – India and Russia.

Lastly, the March Report lists a substantial number of measures improving the non-discriminatory access of small and medium enterprises to export credit and foreign direct investment schemes. Such measures aim at reducing the domestic distortions between large firms (which already benefit from the measures in question) and small and medium enterprises which were excluded from such benefits, often out of mere bureaucratic neglect. They may involve small quantities, but their non-discriminatory nature enlarges vastly the range of products and competitors that would be available on the world markets.

Table 3.1B provides the equivalent information for the period running from April to September 2009. As a first glance, the balance between market-opening measures and protectionist measures seems to have notably changed. However, the reality is much more nuanced.

First, the increase in protectionist measures is entirely related to antidumping and countervailing cases. But, most of the cases listed in the September Report

Table 3.1A: *Trade-related Measures (late 2008 to March 2009)*

	Market-opening measures				Protectionist measures					
		based on								
	All	import	export	others	All	tariffs	AD (a)	NTBs (b)	Subsid. & taxes	Public proc. & labor
Argentina	1		1		5		1	3	1	
Australia										
Brazil	1		1		1		1			
Canada	3	1		2	3		3			
China	4		4		5	1	1	2	1	
EC	1			1		9	1	7		1
India	5	1	4	1	9	2	2	5		
Indonesia	1	1			8	1		7		
Japan					1		1			
Korea					1	1				
Malaysia	1	1			2		1	1		
Mexico	1	1			1	1				
Russia	4	1	3		3	2		2		
Taiwan					3		2			1
Turkey					3	1	2			
USA	1			1	5		1	1		3
Total above	23	6	13	5	59	10	22	21	3	4
All economies	28	9	15	5	68	16	23	22	3	5

Source: WTO March 2009, Annex I.
Notes: (a) AD: antidumping cases (initiations, reviews or measures); (b) NTBs: non-tariff barriers.

Table 3.1B: *Trade-related Measures (April to September 2009)*

	Market-opening measures				Protectionist measures					
		based on								
	All	import	export	others	All	tariffs	AD (a)	NTBs (b)	Subsid. & taxes	Public proc. & labor
Argentina	1	1			9		5	4		
Australia					2		2			
Brazil	1	1			5	1	3	1		
Canada	1	1			4		4			
China	1		1		10		1	6		3
EC					6		5		1	
India	1	1			14	1	13			
Indonesia	1			1	2	1		1		
Japan										
Korea										
Malaysia										
Mexico	1			1						
Russia	7	7			8	8				
South Africa					1	1				
Taiwan										
Turkey					4	1	3			
USA					16	0	13		2	1
Total above	14	11	1	2	81	13	49	12	3	4

Source: WTO September 2009, Annex I.
Notes: (a) AD: antidumping cases (initiations, reviews or measures); (b) NTBs: non-tariff barriers.

are only at the initiation stage (even if there is little doubt on their outcomes: on average, 70 to 80 percent of them will end up in some kind of measures) and a dozen of them involve double counting (because there is the initiation of both an antidumping case and a countervailing case for the same product and exporter). Second, market opening measures are less numerous simply because the elimination of barriers on exports has been largely done during the previous period.

As a result, the shift into the WTO language for qualifying the evolution of the situation—from a 'substantial slippage' in protection (March Report) to 'sand in the gears' (September Report)—seems quite appropriate.

2.2 Which rise in antidumping measures?

Second, the most frequent protectionist measures in Tables 3.1 are the antidumping (and countervailing) cases which are the preferred instrument of most vested interests for several reasons: its legal consistency with WTO rules, its notion of apparent fairness that impresses the media and public opinion, and – far above all – its almost infinite capacity to discriminate among foreign exporters, a feature that makes this instrument the 'mother of collusions' among domestic and foreign firms alike, and that makes it a very costly policy for consumers, since it magnifies protection by collusion.

There is thus little doubt that one should expect a sharp increase of such measures, as already documented by Bown (2009) for the third quarter of 2009. Hence, it is important to be careful when assessing such an increase.

First, one should be aware that the base year matters a lot. As shown by Figure 3.1, the year 2007 is a somewhat biased base year since it witnessed the lowest annual number of cases since 1995, and less than two-thirds of the annual average of the complaints initiated in the period 1999 to 2002.

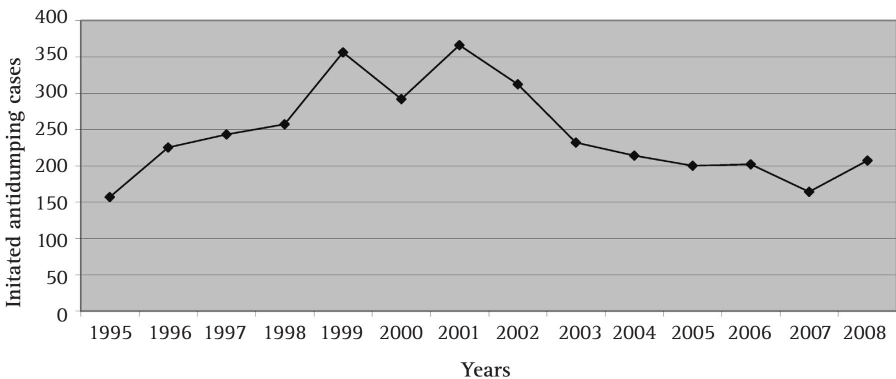

Figure 3.1: *Initiation of Antidumping Cases, 1995–2008*

Sources: WTO website (http://www.wto.org).

Second, suggesting a link between the 2008 rise of antidumping measures and the downturn is inappropriate for a simple reason. The legal duration of antidumping procedures means that measures taken in 2008 correspond to cases initiated 12 months (or even longer) before, that is, a period which was dominated by high prices and by few – to say the least – worries about a severe world economic downturn.

Third, the products listed in the March and September Reports (aluminium, steel fasteners, bars and rods, plastic bags, etc.) have been antidumping addicts for the last two decades at least. Such new antidumping cases aim mostly at 'rejuvenating' old ones. They make data on antidumping activity look bad, but the key question is whether they harm the situation existing in the markets from an economic point of view. This is debateable because most of the new cases aim simply to make clear that the collusion nurtured by past antidumping measures will not be allowed to collapse. In other words, they send clear threats, but they do not introduce significant changes in the already-existing costly distortions of the world market – they simply reveal clearly things that were going on quietly.

That said, a first worrisome sign would be a wider scope of products involved in new antidumping complaints, a sign of distortions spreading to new markets. The March and September Reports do not suggest such an evolution. The only exception is the EC antidumping duty on US biofuels. But the protection granted to EC biofuels did not wait for the recession to reach a staggering level – almost 10000 percent for some biofuels in terms of the effective rate of protection (Amaral 2008). In short, much ado about nothing in antidumping – so far.

A second troubling sign would be a more frequent use of the forms of safeguard with the weakest procedures. The U.S. 35 percent import duties on tires from China is worrisome not so much because of the product *per se* (often subjected to antidumping) but because of the instrument used. For imposing such a duty, the U.S. used the 'transitional product-specific safeguard' (TPS) included in China's WTO protocol accession, raising two concerns. First, it may open the gate to new cases (shoes?) in the U.S. since imposing measures under the TPS is much easier than under any other WTO safeguard, as best illustrated by the fact that the initial petition launching the case was tabled April 20th 2009, and that President Obama announced his decision September 11th 2009—a record time for an 'investigation' (China was particularly frustrated by not getting even a few days of discussions with the U.S. in September). Second, the "trade-diversion" TPS provision means that, as soon as one WTO Member takes a TPS measure, other WTO Members could enforce similar measures at almost no cost in terms of investigation, prior notification, input from parties, etc. As a result, it may be ultimately much more difficult than expected for Chinese firms to shift exports to non-U.S. markets without being hurt again—fuelling frustrations all over the world. The fact that the TPS provision is scheduled to be eliminated in 2014, hence will remain enforceable for the expected full duration of the crisis, is not a source of comfort.

2.3 Other protectionist measures: limited with a couple of exceptions

Tables 3.1 show that non-tariff barriers (NTBs) have not been as active as antidumping. The new NTBs reported consist mostly of licensing schemes, minimum (reference) prices and norms and standards, while quotas are limited to a few products. But, there are only two cases with NTBs covering a wide range of products: mostly licensing schemes in Indonesia (more than 500 products) and reference prices in Argentina (around 1000 products).

Increases in tariffs are limited in terms of both the range of products and tariff rate increase – a good surprise for the vast majority of WTO Members that apply tariffs at a level much below their bound rates, hence that could have raised their tariffs rapidly at no cost in the WTO forum. The only exception is Ecuador, which increased its tariffs on more than 600 tariff lines while decreasing its tariffs on more than 3000 lines, hence increasing the effective rate of protection of the 600 domestically produced goods.

As expected, tariff increases do not occur in countries which apply tariffs as their bound level, and the only exceptions are not unusual. The European Commission reintroduced import duties on certain cereals following a price swing, as it did in the mid-1990s in similar circumstances. China increased its export tax on silicon products subjected to antidumping measures taken by China's trading partners (a measure aimed at appropriating the rents created by foreign antidumping measures on such exports).

2.4 A final overview: the sectors covered

Table 3.2 provides a breakdown by product of all the trade-related measures listed in the March Report (there are more products than measures or countries, because measures often involve several goods or services). The classification used

Table 3.2: Trade-related Measures, by Sector

	All measures	Market opening measures	Protectionist measures	
			number	share (%)
Food-Farm	19	4	15	79
Commodities	14	7	7	50
Cars	4		4	100
Steel	20	5	15	75
Textile	10	3	7	70
Toys	4	1	3	75
Shoes	4	1	3	75
Electronics	5	1	4	80
Chemical	11	2	9	82
Eq.Goods	6	3	3	50
Other goods	36	15	21	58
Services	7	2	5	71
All sectors	140	44	96	69

Source: WTO Annex I (2009).

in Table 3.2 is very crude, and results are not surprising. Changes are largely concentrated among the usual suspects (farm and food products, commodities, steel, textile, and chemicals) and the usual 'second-string' players (cars, toys, shoes, and electronics). The September Report confirms this broad picture.

That said, the share of market-closing measures in all measures varies widely from 50 percent in the commodity and equipment good sectors (showing trade policies in flux) to 100 percent in the car sector (a result which does not include the support from the stimulus packages examined in the next section).

3. THE STIMULUS PACKAGES AND THE BAILOUTS

Annexes II and III of the March and September Reports list the measures taken in the context of the stimulus packages and the bailouts for financial institutions. There have been concerns that such measures could be heavily trade-distorting. A cold assessment of the situation does not support these fears yet, with a couple of exceptions.

3.1 The stimulus packages

A thorough assessment of these packages (Annexes II of the Reports) would require time and skills much beyond those available for this note. Table 3.3 tries simply to give a broad sense of the possible level of discrimination of these stimuli – from level 1 (low discrimination) to level 2 (high discrimination). Two guide-

Table 3.3: *Stimulus Packages (as of March 2009)*

	September 2008–March 2009			April–September 2009			Car sector (a)	
	All discrim.	Low discrim.	High	All discrim.	Low discrim.	High	Sep'08 March09	April09 Sept'09
Argentina								
Australia	4	2	2	3		3	1	1
Brazil	1		1	2		2	2	
Canada	2	1	1	5		5	1	2
China	4	3	1	3		3	3	
EC	20	12	8	39	35	4	6	1
India	1		1					
Indonesia								
Japan	2		2	2	1	1	1	1
Korea	2	1	1	1		1	2	1
Malaysia	3	2	1				1	
Mexico								
Russia	2		2				1	
Taiwan	1	1					2	
Turkey	2	1	1	2	1	1	1	
USA	2	1	1	2		2	2	2
Total above	46	24	22	59	37	22	23	8

Source: WTO Annexes II (2009). (a) The number of measures can be higher than the total in the column 'All' because separate measures on car producers and dealers are distinguished.

lines have been used for getting a sense of the level of discrimination. First, economy-wide stimuli are unlikely to be very discriminatory (they are classified under level 1); second, stimuli focusing on small or medium enterprises and on services may be more discriminatory, hence their classification under level 1 if they cover many sectors, or under level 2 if they focus on few sectors.

Table 3.3 suggests that roughly half of these packages have a low discriminatory impact. Above all, they aim at boosting all economic activity. Three cases raise concerns. First, the level of implementation of the “Buy American” Act is unclear, because it is largely left to the State and local decisions. Second, the level of discrimination of China’s package is also unclear. China is the only country that has taken a systematic sectoral approach under its stimulus package, which is split into 10 sectors. The discriminatory impact will thus depend on the presence of foreign firms in China in each of these sectors.

The last worrisome case is the whole car sector: from assemblers to car-part producers to car dealers. It benefits from stimulus packages in no less than 18 countries, of which six are EC Member States (hereafter ECMS). Some car makers which operate in several countries are thus likely to benefit from several packages. There are still substantial subsidies during the recent months. These features make the car sector the best candidate for a ‘plurilateral’ effort to cut back new protection, as suggested in the conclusion.

3.2 The financial bailouts

Annexes III of the March and September Reports lists 65 and 32 bailout operations, respectively. But 54 and 31 of them have occurred in developed countries, out of which 46 and 30 are in the European Community and 3 (none in the September Report) are in the United States, consistent with the fact that the crisis was fuelled by mistakes in financial regulations in developed countries. The high number of measures in the European Community mirrors both the many (18) ECMS involved, and the fact that the ECMS have followed a trial-and-error process in solving their problems.

The crucial question from the trade perspective is whether these bailouts have generated any ‘financial nationalism’ – meaning whether banks will turn to policies systematically favouring domestic firms. This question has been fuelled by statements from high officials in several countries insisting on the fact that the banks saved from bankruptcy by public money should lend only to ‘domestic’ firms. Would financial institutions be likely to practise a strong and sustained ‘financial nationalism’—knowing that most of these financial institutions are large or very large?

The answer is probably ‘no’ for several reasons. First, the governments involved in bailouts are eager to give these banks back to the private sector, and the rapidity at which that will occur is perceived as a sign of success of the governments’ policy (the current situation has nothing in common with nationalisations in the past). Such a positive turn of events depends crucially on the capacity of these banks to keep as many foreign clients as possible.

Second, the banks will benefit from the basic principle in politics according to which 'all politics is local'. In coming months, local politicians will realise (they have begun to do so) that jobs in the local subsidiary of a foreign firm are as valuable in terms of votes as jobs in a wholly domestically owned firm. In addition, it is becoming increasingly difficult to define 'domestic' firms after almost 20 years of globalisation. Would a local subsidiary of a foreign firm with most of its business in the country be more (or less) domestic than a domestically owned firm with most of its business outside the country?

4. CONCLUSION

The evidence provided by the March and September Reports does not support a conclusion of 'significant slippage' in protection. Ironically, the major event of the six months of the crisis peak has been the vast liberalisation program launched by Mexico, the seventh-largest world economy. That said, the fact that the economic crisis is not (far from being?) over raises two questions: what to watch first, and what to do now?

4.1 What to watch first?

It is important to watch antidumping and safeguard, but for different reasons. As said above, one type of safeguard (the TPS against China) is dangerous because its weak procedures are an invitation to easy drifts into protection, not only from the first 'mover', but also by other trading partners of China.

Antidumping is dangerous because it is more 'efficient' in imposing protection than any other instrument. Even unbound, tariffs offer much less opportunity to discriminate than antidumping. NTBs which create quantitative restrictions are easy to implement through antidumping, while norm-setting NTBs are cumbersome to define, slow to implement, and hurt exports as well as imports. Subsidies require rich treasuries, an increasingly rare animal, and may trigger ruinous wars.

When could a rise in antidumping complaints occur? Potential complainants have a tactical benefit in waiting for a few months before lodging complaints, if they want to exhibit the largest possible gaps between falls in prices in the exporters' and domestic markets (such gaps determine the amount of antidumping duties).[2] Hence, antidumping activity could be expected to increase late in 2009 or in 2010, depending of the depth and duration of the world crisis. Until then, rumours about rising antidumping activity will be mostly a war of nerves – protectionist forces trying to impress the other side (but, complainants could hasten the lodging of complaints if they fear a jam in the domestic antidumping procedures).

That said, many of these new antidumping cases may simply be designed to 'rejuvenate' old ones, adding little to the messy spaghetti bowl of costly anti-competitive distortions that the current antidumping measures have already generated. The truly worrisome sign to watch out for is a possible widening of

[2] The injury test, always very weak, will be even weaker in coming years if growth remains low.

the scope of products involved in new antidumping complaints, an indication that distortions might be spreading to new markets.

The last instrument to watch carefully is subsidies, as best illustrated by what is happening in the EC. The EC has a system of notifications, transparency and standstill disciplines for subsidies that is so precise and binding, and so strongly linked to the core competition provisions of the Treaty establishing the EC, that it is hard to believe that a similar agreement could ever be achieved at the world level during the next thirty years. Despite such a legal arsenal, EC anti-subsidy disciplines have been extremely disappointing during the past year. Subsidies to carmakers and banks were routinely notified by the EC Member States. But, there is no clear indication that, during the examination of the notified subsidies by the Commission, significant changes have been requested by the Commission and introduced in the initial packages tabled by the EC Member States. And, the whole mechanism ended up in a blanket acceptance by the European Commission of almost all the notified subsidies. It is only very recently that the Commission begun to show some (still limited) willingness to move on this front.

4.2 What to do now?

Watching is not enough. There is a need for new initiatives. A pledge to conclude the Doha Round by 2010 would look like wishful thinking, as long as the US Congress has no appetite for such an endeavour. What else could thus be done?

First, it is time to begin to dismantle the support granted to the car sector. As the United States and the ECMS represent 85 percent of the global US$ 50 billion support, such an initiative could rely on a Transatlantic taskforce (to be extended, if possible, to countries, such as Japan or China). First, this taskforce could assess the extent to which these subsidies are counteracting and (or) amplifying each other. This requires an estimate of the 'subsidy-equivalent' of the car packages, a difficult task because most of them are loans with 'preferential' interest rates, not straight subsidies.[3] Second, the taskforce could facilitate the progressive elimination of the huge excess capacity in world car production. This new approach would shift the efforts to protecting workers – not jobs or firms (for instance, see OECD 2005).

All this looks terribly similar to the 1970s or 1980s. But, today's environment is quite different. Public opinion is realising that nothing is more 'tradeable' than a subsidy in a globalised economy. Granting a one Euro subsidy to a firm allows the firm to save the one Euro it already owns and to invest it where it wants, while spending the subsidised Euro in accordance with the political wishes of the moment.[4] Despite their best endeavours, no government can stop tradeable subsidies without imposing large costs on the domestic economy. Emerging new al-

[3] In fact, these interest rates can be substantial (8 percent for the French loan to the French carmakers).

[4] For instance, out of the first US$ 49.5 billion granted to the US insurer AIG by December 2008, 24.3 billion (49 percent) ended up at six European banks (Société Générale, Deutsche Bank, UBS, Calyon, Barclays and Rabobank) (*International Herald Tribune*, March 18, 2009).

liances in the car sector will inevitably increase concerns about 'tradeable' subsidies, and about attrition in competition, with its costs to consumers *and* workers alike.

Another key difference with the 1970s and 1980s is that today, firms see public support as a threat to their reputation. It is remarkable that some banks and firms declined quickly in public support – such as Deutsche Bank, Crédit Suisse, Ford, or Volvo (in France). Since then, the news has shown banks and firms trying to escape from the packages, and developing a strategy to brand themselves as more robust and independent than their competitors. These efforts reveal the difficulty in designing a broad, sensible subsidy policy in a globalised economy.[5]

A second – much more ambitious – initiative would be to launch serious negotiations on services liberalisation, as suggested in detail in another paper (Messerlin and van der Marel 2009). The paper examines the option of Transatlantic negotiations in services. Beyond its immediate gains and feasibility, this option has an attractive feature: it generates dynamic forces that induce the United States and the European Community to extend their talks to about a dozen countries – reaching a threshold of more than 80 percent of output in almost all service industries. As a result, such a Transatlantic initiative on services holds out the prospect of considerable gains and opportunities for consumers and producers on both sides of the Atlantic, at a time of considerable economic challenges. 'Leading with Services' is also a winning strategy for concluding the Doha Round, given the magnitude of economic gains which could be unleashed. Services could effectively be put into the driving seat of the WTO negotiations, where they belong, and not held hostage to agriculture and manufacturing, a major reason for the defensive tactics that have plagued the talks for years.

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[5] For instance, while returning $10 billion in US government money (under the TARP package), Goldman and Sachs will retain access to FDIC support which is cheaper from an economic, political, and a reputational point of view (*International Herald Tribune*, April 16, 2009).

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4

Business Perceptions of Changes in Non-Tariff Trade Measures

CAROLIN AVERBECK, ELISA GAMBERONI, MONDHER MIMOUNI AND OLGA SKOROBOGATOVA

1. INTRODUCTION

Because of the global recession, concerns over a surge in protectionism have intensified. In the past quarter, trade has fallen significantly, and the World Bank now forecasts a 10 percent drop for 2009. With lags in labour markets implying that job losses will continue even after recovery has begun, the G20 called for a close monitoring of trade policy measures. In its *Report on the Financial and Economic Crisis and Trade-related Developments*, the WTO also warns about the dangers of protectionism.

Protectionism can occur through various channels, such as subsidies, an increase in tariff rates, and a rise in the application of non-tariff measures. An analysis of the changes in the tariff rates between 2008 and 2009 recently undertaken by the International Trade Centre (ITC) for a number of countries has revealed only minor differences, not leading to any significant effect on trade. Compared to tariffs, non-tariff measures (NTMs) is an area which is considerably more difficult to monitor and analyse, as these include a wide range of requirements which vary from country to country.

NTMs can be defined as policy measures, other than ordinary customs tariffs, that can potentially have an economic effect on international trade in goods, changing traded quantities, prices or both. These measures include a wide category of instruments such as sanitary and phytosanitary regulations (SPS), technical barriers to trade (TBT), quotas, licenses, export restrictions, custom surcharges, financial measures, antidumping measures, and other anticompetitive measures.

NTMs are generally introduced for legitimate reasons, such as protection of human health. However, some countries may have incentives to misuse NTMs to shield domestic industries, in particular at the times of a crisis. NTMs can be turned into barriers by tightening the requirements or introducing new measures in such a way that impedes import or export. It's difficult to distinguish between justified NTMs and protectionist measures in disguise.

Monitoring of NTMs can increase transparency about their use and impact on trade. In practice, monitoring is severely affected by a lack of data. Existing NTM databases are limited and outdated. UNCTAD's TRAINS database, which covers regulations at the country- and product-level, was last updated in 2001. It does not allow searching by affected countries, uses an outdated classification of NTMs, and is far from being complete. WTO notifications on SPS and TBT measures are more up-to-date than TRAINS, but they do not cover many types of NTMs that are encompassed in the definition provided above. Countries notify the WTO only on the measures that they are willing to report and that are regarded as barriers. The Global Trade Alert (GTA) is a welcome initiative that is helping to fill in this gap. This website went live in June 2009 and provides information on state measures taken during the current global downturn. The impact of the reported measure on trade is assessed by a team of researchers. While the website does not provide a full coverage of applied measures, it offers an important complement to other sources of information (GTA, 2009).

The existing databases do not take into consideration the impact of NTMs on exporting and importing companies. Firm-level information on the application and incidence of NTMs as they affect their operations can be only captured through company-level surveys. Although such surveys can only record perceptions and are thus subjective, firms will be among the first to be confronted with new measures or more stringent application of already existing measures. Thus, firm surveys can be an important supplementary source of data on changes in NTMs.

This note analyzes NTMs at a time of crisis. It is based on GTA data and company-level surveys undertaken by the ITC and the World Bank in four developing countries: Chile, the Philippines, Tunisia and Uganda.

2. NEW NTMS AND "TRADE AT RISK"

The GTA website provides information on the type of measures introduced by countries from November 2008 onwards. The sources of the data are newspapers and national sources; users can report "suspicious" measures to the portal; these measures will be then assessed by an independent network of research institutes and trade experts. The measures are categorized according to their nature (i.e. tariffs, sanitary and phytosanitary measures, subsidies, etc.), their implementation status ("announced" versus "implemented") and their potential disruptive impact on partner country exports/imports. For a large share of the reported measures, the GTA website also provides information on the implementing jurisdiction, the affected countries, the date of inception and the tariff lines affected by the measure. However, these data have to be interpreted and used with caution. The measures are assessed based on the judgement of researchers, and the Global Trade Alert website does not always provide a very clear definition of a measure and the level of disaggregation at which it is applied. Moreover, official sources have not provided or reviewed the website's content. Given the way that the portal is

populated, it risks to be incomplete – some measures may not be captured, and some that were reported to the portal may not be considered by the reporter to be “suspicious”.

Despite the data limitations, the measures that have been reported to the Global Trade Alert provide valuable information. The data indicate that NTMs adopted since November 2008 have risen in waves (Figure 4.1). The peak seems to be in the first and second quarter of 2009. It should be noted that the number of affected tariff lines or the number of affected countries is not taken into consideration.

Based on the Global Trade Alert data, in Figure 4.2 we illustrate the number of measures that affect each of the four countries in which surveys were undertaken (Chile, the Philippines, Tunisia and Uganda) during the period under analysis (until end of May 2009). Figure 4.2 only showcases those measures that that are categorized as trade-disrupting by the GTA website; as mentioned, the number of tariff lines affected by the measures are not considered. The number of measures that have been implemented by countries throughout the crisis, and assessed as “trade-disrupting” by the Global Trade Alert website, is highest for the Philippines, followed by Tunisia and Chile.

A simple counting of the number on measures is a crude proxy of the incidence of NTM use. Using the information provided by the Global Trade Alert, we can also compute the share of 2007 exports that is potentially at risk, considering the number of measures adopted or announced and adopted until the end of May 2009 as well as the affected tariff lines. The results are mapped in Figure 4.3,

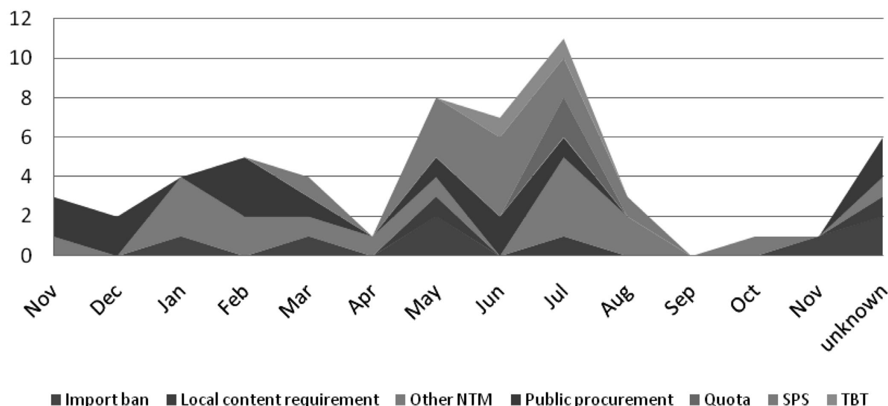

Figure 4.1: *The Use of NTMs*
Number of implemented measures by inception date

Data source: World Bank Staff as calculated from the Global Trade Alert database (http://www.globaltradealert.org/).

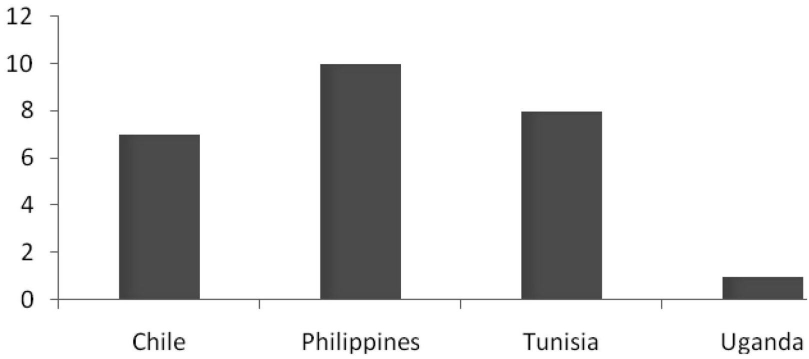

Figure 4.2: *Number of NTMs Affecting Exports, November 2008–May 2009*

Data source: World Bank Staff as calculated from the Global Trade Alert database.

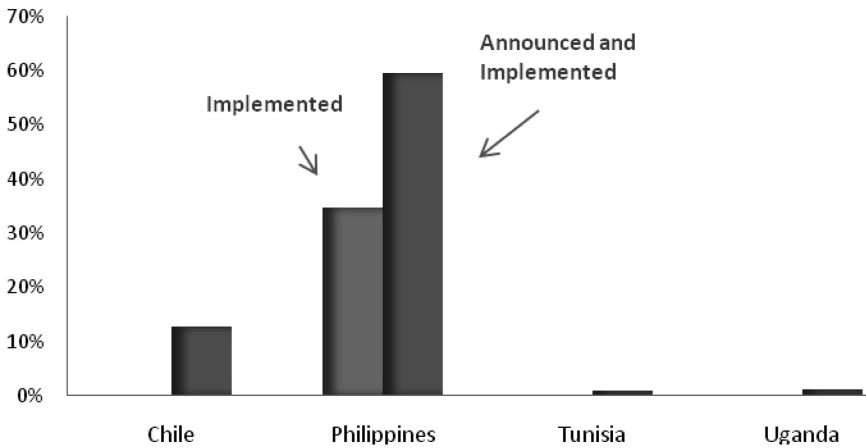

Figure 4.3: *Share of Exports at Risk of Being Attacked by NTMs (based on 2007 export data)*

Data source: World Bank Staff as calculated from the Global Trade Alert database.

which shows that about 35 percent of Philippines' exports in 2007 is potentially subject to the measures that the Global Trade Alert website assessed as "trade disrupting". Moreover, for certain countries, the implementation of announced measures affects a large share of their exports. For example, the share of 2007 exports potentially at risk for Chile jumps from 0.5 percent to about 10 percent. Note, however, that this back of the envelope calculation does not consider the drop in demand that follows naturally during an economic downturn – clearly an important caveat.

These preliminary findings are confirmed by the firm-level survey results from the four countries: depending on the country, the interviewed companies assessed the impact of the crisis differently.

In the following section, we analyze the data from two interrelated surveys on the perception of the business sector regarding the use and incidence of NTMs during the crisis. The analysis of perceptions is subject to well-known methodological caveats that are worthy of mention. First, business perceptions may only imperfectly reflect reality. For example it may be that since many NTMs generate fixed compliance costs, the fact that fewer exports are accessing a market (because of the drop in demand) may increase their relative (per unit) costs. Second, perceptions can easily conflate cultural, technical and protectionist intent. Third, one country may have experienced many more forms of contingent protection than another over several years and this might color the view of that country about recent changes in the use of NTMs. These factors suggest caution is needed about making cross-country comparisons. On the other hand, the surveys provide some useful insights for governments as they illuminate the situation faced by exporters across different regions.

3. BENCHMARKING BUSINESS PERCEPTIONS

In the course of the last two years ITC has conducted two NTM surveys. The first one, a joint initiative with UNCTAD, was finalised by the third quarter of 2008.[1] The second survey, in cooperation with the World Bank, was executed in May 2009.

The first survey will serve as a baseline assessing how companies perceived the situation before the crisis. The surveys were conducted in seven developing countries, namely Brazil, Chile, India, the Philippines, Thailand, Tunisia, and Uganda. The surveys aimed to increase understanding on non-tariff obstacles to trade by capturing and classifying problems experienced by the business sector. More than 7,000 firms were contacted from which 1,730 companies from various sectors

[1] The survey is one component of the NTM project, the other one being official NTM data. During the pilot phase of the project, ITC and UNCTAD executed surveys in seven countries to test a new methodology for the systematic collection, classification, and dissemination of NTM data based on the new NTM classification. The UNCTAD NTM Classification was prepared in a multi-agency framework with technical inputs from several international organisations and institutions, including ITC and the World Bank.

participated in the survey through face-to-face interviews executed by trained local partners. The surveys were finalised in the third quarter of 2008, before the full rise of the current financial and economic crisis. These surveys are referred to hereafter as the 'initial surveys'.

The initial surveys differentiate between 'non-tariff measures' (NTMs) and 'non-tariff barriers' (NTBs) and were designed to capture what companies perceive as barriers to trade. In general, NTMs refer to a wide range of measures, including technical regulations and product standards as well as customs procedures, which might be applied for legitimate reasons, for example protection of health or consumer safety (see Appendix 1 for definitions). NTMs partly reflect the increasing sophistication of markets, with consumers demanding more information about the products they buy.

The term NTB is used to denote a subset of NTMs, including those used as instruments of protection and requirements that companies perceive as very difficult (costly) to comply with. From a company's perspective, even legitimate measures can increase their trade-related costs to a prohibitive level. Furthermore, the way NTMs are applied (rather than the measure itself) can also constitute an obstacle to trade, such as unjustified delays in obtaining authorisation or certificates. To shed light on this complex picture, the initial surveys aimed to identify those measures that companies *perceive* as NTBs, and to capture obstacles arising from the manner in which the measure is applied by partner countries, as well as bottlenecks at the national level.

The surveys were administered in the same manner in all participating countries. However, specific differences were identified in each country owing to the nature of the topic itself, different levels of local expertise and activities on the topic, local language requirements, and cultural differences. For example, in one country, the interviewed companies only reluctantly shared their experiences on non-tariff obstacles to trade, because they considered this information a potential source of competitive advantage over their local competitors. Consequently, the results can show only overall tendencies across countries.

Despite these limitations, the surveys provide useful insights to the companies' experiences across different regions, including patterns of use by product sectors and partner countries. The results from four out of seven countries (Chile, the Philippines, Tunisia, and Uganda) are presented below, as these four countries also participated in the follow-up surveys that focused on changes in NTM perceptions during the crisis. What follows primarily focuses on the experience of exporting companies, although importing companies also took part in the surveys. Companies reported their experience with obstacles to trade by 'case'. Each case has several parameters, including the exported product, the relevant NTM, the partner country applying the NTM, as well as the description of the challenges the exporter faced when complying with the measure.

Overall results, aggregated across the four countries, show that technical barriers to trade (TBT) and sanitary and phytosanitary measures (SPS) stand out as the most prevalent form of NTB (Figure 4.4).

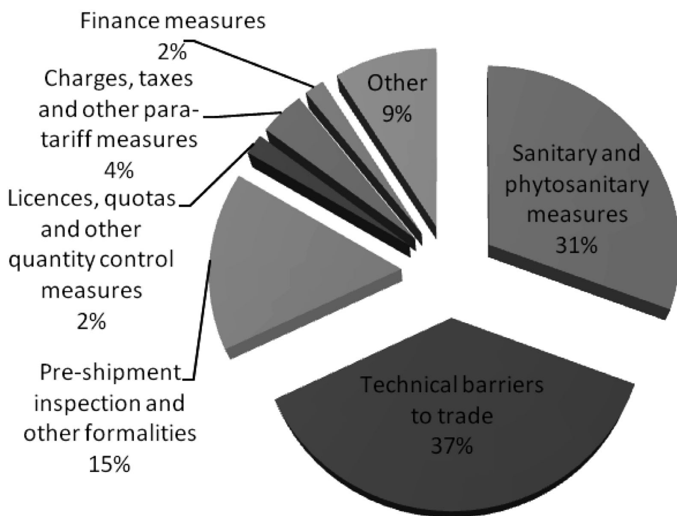

Figure 4.4: *Business Sector Reports Greater Difficulties with SPS and TBT Measures*

Source: Initial surveys, 2008.
Note: Percentages denote cross-country averages of the shares of each type of measure per country.

The individual results from each of the surveyed countries all show the prevalence of TBT and SPS measures, but also a considerable degree of cross-country variation in the incidence of other types of measures. In Tunisia and Uganda, customs formalities and pre-shipment inspection are of much more concern to the private sector than they are in the other surveyed countries. The share of licences, quotas, and other quantity control measures reported by Chilean companies are three times higher than in the other three countries. The surveyed Philippine companies reported the highest share of SPS and TBT measures, among which certification requirements have the highest incidence (almost 29 percent of all reported cases).

The analysis of the results suggests that the prevailing types of barriers are linked to the partner countries (Mimouni et al. 2009). For the Chilean business sector, exporting to Latin America is the most challenging, with labelling, marking, and packaging requirements reported most often among the measures with which it is difficult to comply. Ugandan companies also encounter most of the obstacles while trading regionally, and they reported that inspection and clearance formalities, as well as special customs formalities not related to SPS and TBT are among the most prevalent measures. The interviews with Tunisian companies show that the most affected exports are those destined for the European Union, a very close market for them geographically and historically. Tunisian companies exporting to the European Union mostly reported measures related to traceability requirements, as well labelling, marking, and packaging requirements. The

highest share of cases captured by the survey in the Philippines (above 28 percent) is related to exporting to the United States, with interviewed companies being most often concerned about certification requirements and traceability requirements. In all the surveyed countries, companies report very few obstacles to trade when exporting to the Asia-Pacific region.

Results related to partner (importing) countries should be taken with a degree of caution. The causes that lead an exporting company to qualify an applied measure as problematic are not necessarily associated with the country that applies the measure. The obstacles may be caused by factors linked to the home country of the exporter, for example a lack of infrastructure or a lack of efficient procedures. Moreover, constraints are clearly particular to each country, because companies in one country may be better able to deal with certain requirements rather than others are, or because the structure of product-by-partner destination countries influence the type of barriers exporters face.

4. COMPANIES PERCEPTION ON TRADE MEASURES DURING THE CRISIS

In the light of the commitments made in April 2009 by the G20 countries, which include promoting global trade and investment and rejecting protectionism, it is important to know whether the business sector has experienced an increase in protectionist measures. If such measures have taken place, what is their effect on the companies across countries? If companies have not experienced any new trade restrictive measures, are they affected by the current crisis through other channels? Likewise, has the business sector already benefited from a promised increase in trade facilitation?

To address these questions, in May 2009 the ITC and the World Bank executed a second set of complementary surveys (referred hereafter as ‘follow-up surveys’). These surveys were based on phone interviews, mostly with the same companies that had already participated in the first survey. Nearly a thousand companies – from Chile, the Philippines, Tunisia, and Uganda – responded to the questions on the most serious effects of the current crisis on their operations, as well as on new trade restrictive and trade facilitating measures implemented in the past six months, or existing measures applied more vigorously as a result of the crisis. The follow-up surveys encompassed questions on a wide range of trade measures, including both tariff and non-tariff measures.

The overall results of the follow-up surveys suggest that about 80 percent of the interviewed companies are affected by the current crisis (Figure 4.5 below). More than half of all surveyed companies report that the principal cause has been a drop in demand, and about a quarter pointed to a more restrictive business environment.

The business sector is challenged by decreasing demand in both foreign and domestic markets (40 and 17 percent of responses, respectively). Companies that

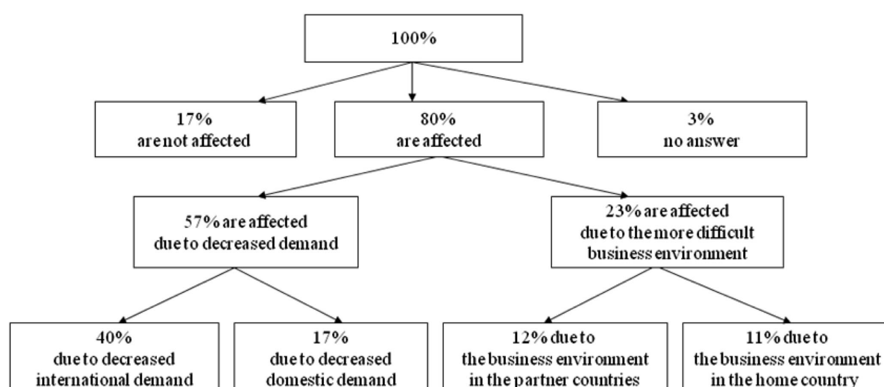

Figure 4.5: *Companies State the Most Serious Effects of the Current Crisis*

Source: Follow-up surveys, 2009.

indicated that decreasing international demand has had the most serious effect of the crisis on their operations also provided information on partner countries (Table 4.1). Companies in Chile referred to countries in Latin America and the Caribbean most of the time, even though altogether they account for 17 percent of total exports. Companies in the Philippines reported declining demand in the EU and US markets in the majority of cases, while Ugandan companies are mostly affected by the falling African demand.

Table 4.1: *The Business Sector is Affected by Decreasing International Demand*

Partner countries	Chile		Philippines		Uganda	
	Share of reports on reduced	Share of export (%)	Share of reports on reduced	Share of export (%)	Share of reports on reduced	Share of export (%)
Canada	2.8	1.8	4.3	0.5	0.0	0.2
China	4.6	15.2	4.3	11.4	0.0	1.1
Japan	2.8	10.8	4.3	14.5	0.0	0.4
European Union	27.5	19.3	21.4	16.7	6.3	24.0
USA	11.9	12.8	57.1	17.0	0.0	1.5
Africa	0.9	0.3	0.0	0.4	87.5	44.5
Asia other than China and Japan	9.2	15.1	5.7	36.6	0.0	18.2
Europe other than EU	2.8	6.0	0.0	0.5	6.3	7.0
Oceania	0.0	0.5	2.9	1.6	0.0	0.2
Southern America and Caribbean	37.6	16.7	0.0	0.8	0.0	0.3
Total number of reports	109		70		16	

Source: Follow-up surveys 2009; ITC Trade Map 2007.
Note: Tunisia is omitted, as respondents do not specify partner countries with diminishing demand.

As expected, the figures on shrinking international demand reflect the export structure of the surveyed countries. Although a large share of world trade is occurring within global supply chains, some products are likely to be more affected by the changing demand than others are. In general, consumers can reduce their purchases of cars and automotive components, electronics, and textiles more easily than of foodstuff and other agricultural products, while producers keep importing fuels, minerals, and other natural resources. Consequently, the business sector in countries like the Philippines, mainly exporting electronic equipment and machinery, seem to be more affected by decreasing demand than countries like Uganda, which mainly produces agricultural products. Tunisian companies are likely to be affected because they mainly export to crisis-hit France and other European countries.

With regard to a more difficult business environment, responses mention the international and the domestic business environment in almost equal proportions (12 and 11 percent respectively). When speaking about the domestic business environment, the most prevalent concern for the companies is trade finance. The reports of the interviewed companies on a more restrictive international business environment can be linked to the new trade restrictive measures, and existing measures implemented more vigorously by the partner countries because of the crisis.

The largest share of affected companies, according to the 2009 follow-up survey, is in the Philippines. Almost half of the firms interviewed in this country have experienced new trade restrictive measures that trading partners have introduced during the past six months. The partners, that introduced new measures, are most often countries in Asia, Northern America, and Europe. The new measures reported in the follow-up survey in the Philippines are mostly related to certification requirements, testing requirements, and pre-shipment inspection. The companies do not directly attribute these new restrictions to the crisis, yet comment that their impact has heightened. The distribution of the types of NTMs and partner countries mirrors the situation before the crisis (which was captured during the initial survey in 2008). This also supports the conclusion that reported measures were already in place before the crisis, yet became more burdensome to comply with during the crisis.

Contrary to the case of the Philippines, only a few Ugandan companies report new trade restrictive measures (Figure 4.6).This is in line with the preliminary analysis carried at the beginning of the paper (Figure 4.3), where we showed that little exports from Uganda was potentially at risk given the measures implemented and/or announced until the end of May 2009.However, when asked to provide a general comment on the current situation, Ugandan companies suggested that the current financial crisis is impairing their ability to export and import. About a third of all interviewed companies are concerned about the dollar appreciation limiting their ability to produce, since imports of raw materials were becoming too expensive. Other prevailing concerns include the increased cost of local intermediates, delays in worker remittances leading to reduced local de-

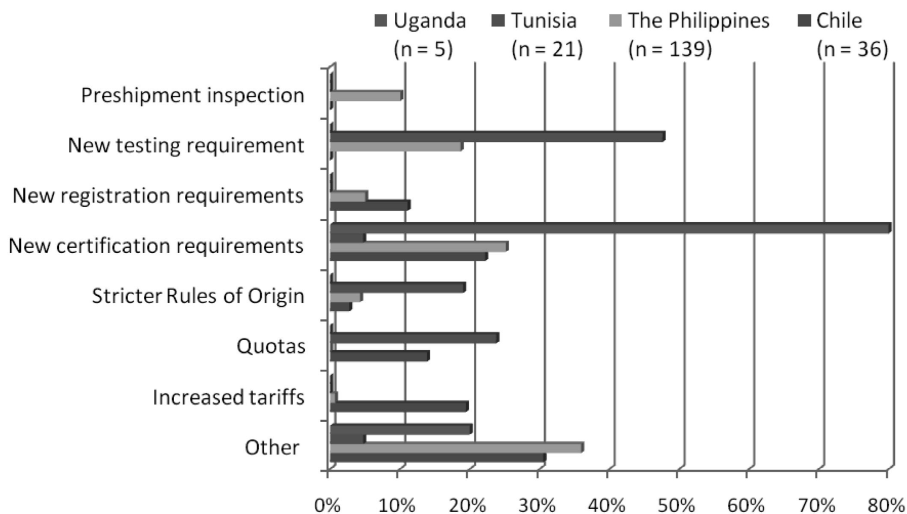

Figure 4.6: *Types of New Restrictions that the Partner Countries Implemented*

Source: Follow-up surveys, 2009.

mand, as well as delays in payments. Regarding the latter point, Ugandan companies suggested that while before the crisis payment arrived in 3 to 4 days, since the financial crisis payments were made after 2 to 3 weeks.

In Chile, companies reported 36 cases related to the new measures implemented by their partner countries. Albeit the number is limited, in a period of shrunken demand, single measures could have drastic effects on the ability of companies to survive during the crisis. Indeed, the companies indicate that demand on average has dropped by more than 30 percent. Most of the cases of new trade restrictive measures reported by Chilean companies during the follow-up survey involve NTMs, and in particular certification requirements. Some of these measures can be linked to the official information released by Chile's trading partners. For example, Annex 1 of the WTO report (WTO 2009) contains a reference to non-automatic licensing requirements temporarily introduced by Argentina and covering textile, steel, metallurgical products, and tyres. These requirements were also reported by one of the companies interviewed in Chile. As illustrated in Figure 4.3, the implementation of announced measures would put at risk a considerable amount of Chilean exports.

The analysis of trading partners shows that in the case of Chile almost two-thirds of all new measures have been implemented by importing countries in Latin America (Figure 4.7 below). These findings are similar to the finding of the initial survey: the intra-regional trade of Chile is more affected by non-tariff barriers than the trade with other regions. In the initial survey, companies also reported that they encountered most of the barriers when trading with the United

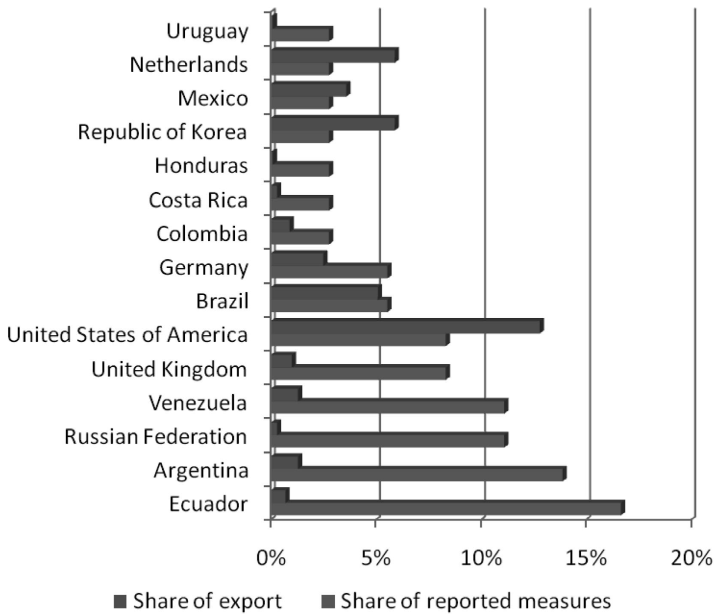

Figure 4.7: *Partner Countries that Introduced New Trade Restrictive Measures, as Reported by Chilean Companies (n=36)*

Source: Follow-up surveys 2009; ITC Trade Map 2007.

States, Japan, and the Russian Federation. The United States and the Russian Federation reappeared in the follow-up survey as countries that had initiated trade restrictive measures in the past six months. The magnitude of the cases reported by Chilean exporters on Russia, both in the 2008 and 2009 surveys, is very high when juxtaposed to the share of Chilean total export value bound for Russia (0.3 percent).

The impact of the depressed demand can be offset by trade facilitation and liberalisation measures. However, only 12 percent of the surveyed companies in the Philippines and 8 percent each in Chile and in Tunisia reported that they had experienced such measures introduced by their home governments in reaction to the crisis. Nearly half of these measures in Chile and 80 percent in Tunisia referred to trade finance. This may suggest that certain measures can offset the dramatic impact of the crisis. In the Philippines, 8 percent of the responses were related to trade finance, while the majority credited their national government for helping them to keep abreast with the latest regulations ahead of actual shipment'. Contrary to the business sector in other countries, Ugandan companies reported that they had not benefited from any measures introduced to liberalise or facilitate trade. A possible explanation could be that a less developed country may not have enough means to introduce such measures.

5. CONCLUSION

NTMs figure prominently in what the WTO has called “low-intensity” protectionism. As demonstrated by the discussion in this paper, these measures are difficult to track because they lack transparency and are idiosyncratic. While the number of NTMs increased in the first and second quarter of 2009 according to the Global Trade Alert, businesses in three out the four countries surveyed report that they have not been adversely affected. However, firms in the Philippines report a different story and flagged significant concern about more restrictive NTMs affecting their exports. These concerns seem well-grounded when juxtaposed with the GTA data – some 35 percent of Philippine exports were exposed to some type of NTM. From the perspective of the interviewed business sector, governments have not implemented new measures but rather have tightened the restrictiveness of existing NTMs. Moreover, the GTA data raise a cautionary flag for Chile: if “measures announced” eventually were to be implemented, a significant share (some 10 percent) of exports may be affected by restrictive NTMs.

As has been stressed before, the available information on NTMs is only partial. Several caveats must be kept in mind. First, neither the Global Trade Alert nor the surveys tell us anything about the degree of restrictiveness of an NTM (or all NTMs) for any product. The effects may be large or they may be inconsequential, which is why we have used the term “at risk”. Second, the Global Trade Alert began only after the crisis. The absence of comparable pre-crisis data makes it difficult to say much about the trend in the use of NTMs. Third, the surveys did not aspire to be representative and this might bias the results. Finally, the surveys deal with perception; hence previous experiences might drive the response of the interviewed firms. These caveats notwithstanding, it is clear that NTMs require careful and more systematic monitoring than they received to date.

One bright spot is that interviewed companies praised the domestic interventions related to trade finance and access to information as measures that reduce their trade costs. Trade facilitation measures appear to pay dividends, particularly in Tunisia, but these new sets of measures are not equally spread across companies surveyed. Indeed, governments and international financial institutions are launching new initiatives to support trade. The World Bank Group, for example, helps to reinforce the capacities of the regional and national financial institutions through its Global Trade Liquidity Program, has created a Trade Facilitation Facility to provide grants to lower trade costs and, along with the International Trade Centre, World Customs Organization and other partners , is working with the private sector in a newly created Aid for Trade Facilitation Partnership. At the international level, the commitment not to use NTMs for protectionist aims, and transparency of macroeconomic policy and data remain priorities. These efforts are more likely to bear fruit if the G20 honours its pledge and avoid protectionism, including NTMs.

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DATA SOURCES

Comtrade database

Global Trade Alert website: www.globaltradealert.org

International Trade Centre, Market Analysis Tools (Market Access Map and Trade Map) www.intracen.org/marketanalysis

APPENDIX 1: DEFINITIONS OF NON-TARIFF MEASURES

Several of the most prevalent types of NTMs are mentioned in the article. Their definitions provided below are based on a new NTM classification prepared by a multi-agency team within the framework of UNCTAD's initiative on NTMs.

A.1 Technical measures to trade refer to product characteristics or their related process and production methods. These measures include packaging, marking, and labelling requirements as well as conformity assessment procedures.

Within the multilateral context, these measures are categorised into 'technical barriers to trade' (TBT) and 'sanitary and phytosanitary measures' (SPS), depending on the purpose of the measures. SPS are designed to protect human, animal, and plant life or health from risks caused by pests, diseases, and disease-carrying or disease-causing organisms; and risks arising from additives, contaminants, toxins, or disease-causing organisms in foods, beverages, or feedstuffs. TBT are applied for the purpose of national security, protection of human safety, protection of the environment, and prevention of deceptive practices.

This article covers the following most reported sub-categories of technical measures:

- *Traceability requirements:* These relate to measures on the disclosure of information concerning different stages of the production process and the distribution of a certain product, such as the origin of materials used, processing history, and so on.
- *Labelling, marking, and packaging requirements:* Labelling is a requirement to provide certain information on products, or their production process, while marking is providing information that the product should carry for transport and customs purposes. Packaging requirements relate to the way products can be packed and to the packaging materials.
- *Testing requirements, conformity assessment procedures*: These are required by the importing country that envisages verifying the conformity of the products to certain SPS or TBT regulations by testing or sampling.
- *Certification requirements:* These concern certification that is required by the importing country and is issued by either the importing or the exporting country; its purpose is to verify the conformity of products to certain conditions.

A.2 Pre-shipment inspection and other customs formalities include all the measures related to inspection of the products in the country of export before shipment, as well as special customs formalities not related to TBT or SPS, for example the requirement that a particular shipment must pass through a specified port of customs.

A.3 Licences, quotas, and other quantity control measures include the requirements on different forms of licensing, quotas, and prohibitions.

A.4 Charges, taxes, and other para-tariff measures include all the measures related to charges: taxes on imports that are not tariffs, such as internal taxes on imports; general sales taxes; excise taxes and charges; and decreed customs valuations.

A.5 Finance measures regulate the access to and cost of foreign exchange for imports and define the terms of payment, for example advance payment requirement, multiple exchange rates, restrictive official foreign exchange allocations, regulations related to terms of payment for imports, transfer delays, and surrender requirements.

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5

Can International Economic Law Constrain Protectionism?

ANNE VAN AAKEN AND JÜRGEN KURTZ

1. INTRODUCTION

Economists and political scientists have begun to isolate the causes and implications of the spread of the global financial and economic crisis in late 2008. Critical attention – often accompanied by strident disagreement – has also focused on the efficacy of various domestic plans implemented in response to the crisis. International lawyers have contributed little to these debates. Our analysis aims to redress this gap partly by examining whether and how international economic law might act as a credible constraint on state tendencies towards domestic preference when formalising emergency responses to the crisis.

International economic law comprises a variety of sources, most notably commitments on trading relations and the treatment of foreign investors. The former – international trade law – encompasses bilateral free trade agreements, regional instruments such as the North *American Free Trade Agreement* and the multilateral World Trade Organization (WTO). In comparison, the latter – international investment law – is largely confined to a network of bilateral investment treaties, but also includes key aspects of customary international law.

We believe that international investment law is, in the short term, more likely than any other area of international economic law to give rise to complaint and initiation of legal action. This may, in turn, act as some constraint against the protectionist tendencies evident across state responses to the crisis. Three critical factors might trigger international investment litigation where states have regulated in a discriminatory fashion against foreign investors in the aftermath of the crisis. First, the scope of most investment treaties is typically broader than instruments of trade law (and especially the WTO). This is particularly apparent in the relative absence of exceptions for state conduct under most investment treaties, compared to the detailed and elaborate carve-outs such as the prudential exception in the *Annex on Financial Services* of the WTO *General Agreement on Trade in Services*. Second, in traditional systems dispute settlement at international law (such as in the WTO), the right to initiate a dispute is vested only in state signatories to the relevant treaty. This has important limiting effects in the context of the current crisis as states may rationally refrain from invoking their

legal rights against each other given their own (discriminatory) attempts to respond to the crisis and the possibility of attracting retaliatory litigation.[1] Investment treaties displace this default position by conferring standing on a private party, foreign investors of a signatory state. The foreign investor has the right to initiate action against a host (signatory) state in a range of institutional *fora*, including the World Bank's *Convention on the Settlement of Investment Disputes between States and Nationals of Other States*[2] (ICSID). There is thus no political filter at play in this system; a foreign investor will consider only the commercial imperatives for initiating action and recouping loss caused by state conduct and there is no possibility for the state party to retaliate through cross-claim or other invocation of the system. Third and perhaps most crucially, international investment law is characterised by a range of hard, enforceable remedies adding further incentive to commencement of international litigation. In investment arbitration, the remedy nearly always consists of monetary compensation for loss suffered by the foreign investor. Significant monetary awards have been issued against states under this system, including Argentina who was found to be in breach of investment treaty obligations in the aftermath of its 2001–2 financial crisis.[3]

We begin our analysis in the next section by offering a typology of the typical emergency measures implemented by states to date that are at the greatest risk of breaching commitments under international economic law. We focus here on the early evidence of discrimination directed at foreign investors in the financial sector in the emergency plans of a number of developed states. These varied forms of discrimination are highly likely to constitute breaches of obligations of states under international investment law. To fully contextualise our analysis, we briefly consider in Section 3 select areas of international trade law. Our primary focus is, however, international investment law which we turn to in Section 4. There we review the various forms and sources of international investment law including treaties of *Friendship, Commerce and Navigation*, bilateral investment treaties (BITs), customary international law (CIL) as well as the OECD *National Treatment Instrument*. We identify potential violations of investment law norms across the different categories of surveyed measures. We focus here on two key treaty obligations being the specific protection against discrimination of foreign investors in the obligation of national treatment, as well as the broader guarantee of fair and equitable treatment. We also assess the remote possibilities of es-

[1] Although the Brazilian Foreign Minister Celso Amorim said that Brazil may challenge the legality of a 'Buy American' clause in the recently approved US economic stimulus package at the World Trade Organization, see Raymond Colitt, Brazil may challenge 'Buy American' at WTO, Reuters UK, News of 17 February 2009, available at: http://uk.reuters.com/article/usPoliticsNews/idUKTRE51F52920090217

[2] *Covenant on the Settlement of Investment Disputes between States and National of Other States*, signed in Washington 18 March 1965, entered into force 24 October 1966, 575 UNTS 159; 4 ILM 524 (1965).

[3] See UNCTAD (2008) (detailing that, in 2007 alone, five investment tribunals awarded foreign investors a total of $615 million in damages against Argentina).

caping liability through prudential carve-outs and security exceptions in (some) BITs or CIL. Section 5 ties these lines of inquiry together and concludes.

2. A TYPOLOGY OF EMERGENCY MEASURES TAKEN BY STATES

States have taken different measures in order to save their financial sector and to mitigate the economic downturn. Almost all of those measures were introduced in a very short time period and are often subject to continuing changes. Many measures are codified in law but delegate significant discretion to the executive branch. As these laws are often imprecise and without implementing regulation, the regulatory landscape resembles a 'moving target'. Nevertheless, we will try to categorise the most frequently taken measures with specific relevance to state commitments under international economic law.

These emergency measures can be grouped into three broad categories. They are measures:

1. designed to bolster the stability of the financial services industry;
2. directed at the financial services industry but structured to increase the availability of credit to other sectors of the economy;
3. targeting select and strategic industries (including the automotive industry).[4] We set out below an analysis of individual state measures, highlighting evidence of discrimination against foreign actors, before examining whether and how this might attract liability under international economic law.

2.1 Category 1: Measures directed at the financial services industry

The extensive measures undertaken in this first category are designed to increase the confidence of various market participants and to ensure the continuation of bank funding. They encompass liquidity support, recapitalisation (through nationalisation or otherwise), purchase of specific assets (including 'toxic' bank assets), inter-bank (wholesale) lending guarantees and increases in retail deposit guarantees. We find firm evidence of discrimination directed at foreign investors across these various state measures.

Australia, for example, introduced an insurance scheme for both retail deposits and wholesale lending in early October 2008.[5] The coverage of both guarantees was initially limited to Australian-owned banks and credit unions and Australian incorporated subsidiaries of foreign institutions. Branches of foreign banks – such as Citibank, Credit Suisse, and UBS – were excluded from the insurance scheme. This exclusion triggered flight of wholesale capital from foreign bank branches

[4] For an overview of typical measures taken to date, see *Report to the TPRB from the WTO Director-General on the Financial and Economic Crisis and Trade-Related Developments*, (26 March 2009), Annex 2, available at: http://www.wto.org/english/news_e/news09_e/trdev_dg_report_14apr09_e.doc

[5] *Financial Systems Legislation Amendment* (Financial Claims Schemes and Other Measures) Act 2008 (Cth); Banking Amendment Regulations 2008 (No.1) (Cth).

to domestic guaranteed institutions.[6] Australia is not alone in building adverse incentives for regulatory arbitrage in this area. Ireland has also temporarily guaranteed deposits, covered bonds, senior and dated subordinated debt but only in the six biggest banks of that country, reportedly leading to shifts in deposits to the perceived safety of those guaranteed institutions.[7]

Germany has established a fund to stabilise the financial market by overcoming liquidity shortages and by creating framework conditions for strengthening the capital base of financial institutions. The Act covers *only* financial institutions with their seat in Germany, thereby excluding foreign branch operations.[8] It enables the executive to take various measures, *inter alia,* to assume liabilities accrued by financial-sector enterprises up to an amount of €400 billion and to guarantee liabilities of special purpose vehicles which have assumed risk positions of a financial-sector enterprise.[9] Furthermore, the fund may recapitalise financial-sector firms by acquiring shares or silent participations.[1] It may also overtake risk positions, that is, buy toxic assets, such as receivables, securities, derivatives, rights and obligations from loan commitments.[11] Finally, the Federal Administrative Court is the first and last instance court that can adjudicate on disputes under the Act (except measures with constitutional implications).[12]

The program in the United Kingdom has a broader scope by covering subsidiaries of foreign institutions (as authorised deposit takers).[13] In contrast, Switzerland has elected only to bail out specific institutions taken to be of systemic importance for the financial place Switzerland.[14] To date, the benefits of this *ad hoc* program have only been extended to a national bank – UBS – with a promise to do the same for another, Credit Suisse.

Finally, the position under US law and practice is more nuanced. Early proposals put forward by Secretary of Treasury Henry Paulson excluded foreign banks from the coverage of the US bailout plan. Following concerted lobbying, the *Emergency Economic Stabilization Act* of 2008[15] now authorises purchase of distressed assets (especially mortgage-backed securities) in financial institutions if they have 'significant operations' in the United States. The face of the Act then allows for the possibility of foreign bank participation in the US bailout scheme. This absence of formal differentiation though should be seen in the light of the

[6] Gemma Daley, "Australia Refuses Deposit Guarantee for Foreign Banks", Bloomberg (21 October 2008), www.bloomberg.com (accessed 18 November 2008).

[7] For an overview on the development on deposit insurance schemes in the crisis, see Schich (2008).

[8] Sec. 2 para 1of the *Financial Market Stabilization Act* – Finanzmarktstabilisierungsgesetz of October 17, 2008.

[9] Sec. 6 para 1of the *Financial Market Stabilization Act.*

[10] Sec. 7 para 1of the *Financial Market Stabilization Act.*

[11] Sec. 8 para 1of the *Financial Market Stabilization Act.*

[12] Sec. 15 of the *Financial Market Stabilization Act.*

[13] HM Treasury, Statement on the Government's asset protection scheme, January 19 2009.

[14] Botschaft zu einem Massnahmenpaket zur Stärkung des schweizerischen Finanzsystems of November 5 2008, at 8969. They are well aware of the creation of competitive disadvantages (also of Swiss banks in other countries) but maintain that supporting measures are only available to Swiss banks.

[15] Public Law 110-343.

significant discretion vested in the Treasury Department under the Act. Early reports suggest that domestic US institutions are the majority, if not exclusive recipients, of capital injections under the scheme.[16] Similarly, the 'Public-Private Investment Programme' within the *Troubled Assets Relief Program* foresees the buying of 'toxic assets' up to $1 trillion but also limits access to institutions with 'significant operations' in the United States. If this trend continues, there may be differentiation against foreign institutions as a matter of fact,[17] even if not on the face of the law.

2.2 Category 2: Conditional measures – Provision of credit

The second type of measures also addresses the banking industry but is meant to foster credit to the non-financial industry. The United Kingdom as well as Germany stress in their bailout plans that the provision of credit to national industry, especially SMEs is one of the conditions to be imposed on banks if they take the benefit of the type 1 measures. Given scarce credit availability, lending to foreign industry may well be restricted. In Switzerland, the Swiss Federal Banking Commission (SFBC) has agreed with Credit Suisse and UBS to raise current capital adequacy requirements by 2013. The banks will have to comply with a leverage ratio, in addition to their risk-based capital adequacy requirement[18] but critically, domestic lending activities are exempted from the leverage ratio[19]. This exemption for domestic lending activities sets strong incentives for preferring domestic debtors and potentially shifts available credit away from foreign firms. These various biases towards domestic lending also have a broader spillover effect. Developing countries now face a severe financing shortfall, as investors (including foreign banks) either pull resources out of emerging markets to meet home country conditions or take advantage of lower-risk, newly guaranteed markets in developed states.[20]

2.3 Category 3: Measures targeting 'strategic' sectors

The third category of measure is the most recent and targets strategic industry sectors. In the United States for instance, there are proposals to limit production

[16] See New York Times, October 14th 2008, available at: http://www.nytimes.com/imagepages/2008/10/14/business/14bailout.graphic2.html The list until now contains only financial institution incorporated in the United States.

[17] The development of bond prices of those institutions receiving aid by the state show the immediate effect – their prices go up. This might well be used as a proxy for refinancing costs, crucial for competitive conditions of the market.

[18] HM Treasury, *Statement to the House of Commons on Bank Lending*, January 19th, 2009: "Support small and medium businesses"; the government could now own up to 70 percent of RBS (Royal Bank of Scotland). "In return for this, we have agreed with them an extension of lending commitments to large companies, and an increase in lending over £6 billion in the next 12 months.... These agreements will be specific – covering both the quantity and the type of lending made available to people and businesses across the country...".

[19] Sec. 10 para 2 (1). Financial Market Stabilization Act.

[20] The leverage ratio defines the proportion of core capital to total assets and it will be set for both banks at a minimum of 3 percent at group level and at 4 percent for the individual institutions.

subsidies for the automotive sector to sites that have been in operation for at least 20 years.[21] This condition has the effect of confining those subsidies to the 'Big Three' American automakers (along with one production facility maintained by Toyota in California), since all other production sites of foreign carmakers have been in operation for less than 20 years. Such differential effect may constitute impermissible discrimination under international investment law if foreign carmakers who have invested in the United States do not – as a class – qualify for those subsidies.[22]

Furthermore, the recently passed U.S stimulus package – the *American Recovery and Reinvestment Act* of 2009 (ARRA)[23] – forbids the use of public funds for projects involving public works "unless all of the iron and steel used in the project is produced in the United States".[24] Similarly, Sec. 604(a) of that Act provides that "[e]xcept as otherwise provided ..., funds appropriated or otherwise available to the Department of Homeland Security may not be used for the procurement of [specified items of clothing or equipment] if the item is not grown, reprocessed, reused, or produced in the United States". These measures have been amended – at the insistence of President Obama in the face of threatened trade litigation – so that they "shall be applied in a manner consistent with United States obligations under international agreements".[25] Even with this legal amendment, there is evidence that the actual implementation of this program continues to give preference to government purchases of domestically produced goods.[26]

3. POTENTIAL VIOLATIONS OF INTERNATIONAL TRADE LAW

International trade law comprises the multilateral treaty instruments of the WTO as well as a variety of bilateral and regional trade agreements. We expect this body of treaty law to act as a firm limit on resort to traditional and identifiable forms of protectionism, such as increases in tariffs above bound levels and resort

[21] Media Release of SFBC of 4 December 2008 , available at: http://www.finma.ch/archiv/ebk/e/publik/medienmit/20081204/mm-em-leverageratio-20081204-e.pdf which somehow changes the Verordnung über die Eigenmittel und Risikoverteilung für Banken und Effektenhändler (Eigenmittelverordnung, ERV) of 29. September 2006 (last changed 1. January 2009).

[22] World Bank, "*Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis*", Report prepared for the G20 Finance Ministers and Central Bank Governors, 13-14 March 2009, and World Bank News Release No. 2009/245/EXC; WTO, Report to the TPRB, supra note 4. See also Anthony Faiola and Mary Jordan, "British Bank to the World Takes Its Cash Back Home: Battered RBS Caught in Protectionist Storm", The Washington Post (March 28, 2009), at A1 and A10 (detailing Royal Bank of Scotland's planned closure of branch operations in 15 countries undertaken to comply with the domestic lending requirements of the UK bail-out scheme).

[23] ''Energy Independence and Security Act of 2007''; SEC. 136. ADVANCED TECHNOLOGY VEHICLES MANUFACTURING: INCENTIVE PROGRAM. (g) PRIORITY. – The Secretary shall, in making awards or loans to those manufacturers that have existing facilities, give priority to those facilities that are oldest or have been in existence for at least 20 years. Such facilities can currently be sitting idle".

[24] Measures like car premiums to buy new cars are not discriminatory if they do not put any conditions on the origin of the new car, as is done by Germany, see http://www.bafa.de/bafa/de/wirtschaftsfoerderung/umweltpraemie/index.html

[25] Public Law 111-5, signed into law by President Obama 17 February 2009.

[26] Sec. 1605(a).

to unjustifiable trade remedies (especially antidumping measures). It is far more difficult to predict the likely influence of trade law on the nuanced forms of protectionism surveyed in Section 2 above. This is due to both the hidden or embedded nature of the discrimination practised, and the complexity of the trade instruments in question. We identify below some of these complexities in two key instruments, being the WTO *General Agreement on Trade in Services* (GATS) and the WTO *Agreement on Subsidies and Countervailing Measures* (SCM). These are not the only WTO commitments that might apply[27] nor is our analysis intended to be comprehensive. The next section distils a set of critical issues surrounding the application of these WTO instruments as part of a comparative exercise to identify the potentially broader scope of operation of international investment law, dealt with in Section 4.

As a starting point, the GATS Agreement is relevant for the Category 1 and 2 measures that intervene in the financial services industry. The GATS covers measures that affect 'trade in services', which is defined to include provision of a service through commercial presence. This can encompass foreign investment in the banking and finances sector, regardless of the form and organisation of the investment vehicle.[28] The national treatment Article XVII of the GATS enjoins discrimination directed at foreign services and foreign services suppliers. There are, however, a series of limiters that might constrain the likelihood of a dispute being brought before the WTO based on these GATS provisions. For one thing, specific commitments – including the national treatment Article XVII – *only* apply if a WTO Member State has chosen to list the financial services sector as subject to those commitments. Even if this requirement is satisfied, there is a specific *Annex on Financial Services* in the GATS that preserves the ability of States to adopt and maintain measures for prudential reasons, including those for the stability of the financial system.[29] This exception may offer a safe harbour for those state measures (such as the Swiss intervention) that are justified publicly on systemic and stability grounds.[30]

Second, the various guarantees and government benefits in the Category 1 to 3 measures may potentially violate the disciplines on the provision of domestic subsidies in the WTO SCM Agreement. A 'subsidy' is defined as encompassing four basic elements: (i) a financial contribution[31] (ii) by a government or any public body within the territory of a Member[32] (iii) which confers a benefit[33] (iv)

[27] Sec. 1605(d) and Sec. 604(k).

[28] See Evenett (2009).

[29] Two further possible candidates include the plurilateral WTO *Agreement on Government Procurement and the Agreement on Trade-Related Investment Measures.*

[30] See Art. XXVIII (d) GATS.

[31] GATS *Annex on Financial Services*, para 2 (a).

[32] One should bear in mind however that the prudential exception is limited by certain good faith requirements including that "such measures shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement". *Ibid.* This exception has not been adjudicated in the case law but the good faith qualifications are similar to parts of the chapeau to GATT Article XX. On this latter point, see Leroux (2002), 430 *et seq.*

[33] Those are, for example, grants, loans, equity infusions, loan guarantees, fiscal incentives, the provision of goods or services, the purchase of goods.

to a specific recipient.[34] All of these elements must be satisfied for a subsidy to exist. The SCM Agreement distinguishes between prohibited and actionable subsidies.[35] Prohibited subsidies are those which are conditional on export performance or upon local-content requirements[36], while actionable subsidies require a complaining country to prove that the measure has caused it 'adverse effects' (which includes material injury to domestic industry, or serious prejudice to the state's interests)[37]. Depending on implementation, some of the benefits and guarantees extended by states responding to the crisis might constitute actionable subsidies. There are strategies however by which states can protect themselves from liability in this area. For example, measures which target consumption (and not production) leaving consumers free to choose the goods and services that they purchase, are unlikely to violate the SCM Agreement.[38]

Under the SCM Agreement, a country can use the WTO's dispute-settlement procedure to seek the withdrawal of the subsidy or the removal of its adverse effects (the multilateral avenue). Alternatively, the country can launch its own investigation and charge extra countervailing duty on subsidised imports that are found to be hurting domestic producers (the unilateral avenue).[39] To do so, a Member State must show the existence of a subsidies scheme, an injury to its domestic industry producing a like product, and a causal link between the two. A threat of injury suffices for a lawfully imposed countervailing duty.[40] There may however be important extra-legal and political economy factors that restrain use of these legal avenues. There is widespread use of subsidies in the various emergency measures adopted by a significant proportion of the WTO membership. A choice of a given member to initiate either a WTO complaint or a unilateral response might in turn trigger retaliatory action on the part of the targeted state. This potential for reciprocity of legal action inherent in international trade law is largely absent in international investment law. Investment treaties in-

[34] This applies not only to measures of national governments, but also to measures of sub-national governments and public bodies such as state-owned companies. If newly nationalised banks give credit to domestic firms which they would not have obtained otherwise in the market, these actions would be included. Furthermore, Art. 1.1. *SCM Agreement* distinguishes between direct and indirect subsidies. In the latter the funds are channelled through private institutions, thus a link to a government agency needs to be found. Type II measures could constitute indirect subsidies.

[35] Often the existence of a benefit and its valuation will be clear. This is especially the case in the Type 1 Measures. In case of doubt, the Appellate Body uses the private investor test, that is, the existence of a benefit is to be determined by comparison with the market-place (that is, on the basis of what the recipient could have received in the market); see Canada – Aircraft, WT/DS70*, Report of the Appellate Body.* Art. 14 SCM Agreement provides some guidance with respect to determining whether certain types of measures confer a benefit.

[36] There are four types of 'specificity' within the meaning of the *SCM Agreement*, of which two are of interest here: (i) enterprise-specificity where a government targets a particular company or companies for subsidisation; or (ii) industry-specificity where a particular sector or sectors is targeted for subsidisation.

[37] Non-actionable subsidies no longer exist, Art. 8 *SCM Agreement.* They included subsidies for environmental purposes, to make up for regional inequalities, and the promotion of R&D. They were included on a provisional basis for five years ending 31 December 1999, (Art. 31 SCM).

[38] A detailed list of export subsidies is annexed to the *SCM Agreement.*

[39] Art. 5-6 SCM Agreement.

[40] Report to the TPRB, supra note 4, para 8.

stead confer standing on foreign investors (of a signatory state) to bring legal action against another signatory state and there is no possibility for retaliation by the targeted state. This critical difference may leave investment treaties as the most likely and promising forum to challenge discriminatory state measures.

4. POTENTIAL VIOLATIONS OF INTERNATIONAL INVESTMENT LAW

We now turn to the likely implications that might flow under international investment law from these various differentiations between foreign and domestic actors. It is difficult to formulate a single answer given the heterogeneity of the legal instruments in the field. There are, for instance, important textual differences in the formulation of key protective norms, such as 'national treatment' and 'fair and equitable treatment'. Moreover, certain investment treaties include exceptions for national security and prudential regulation, while these are absent in other instruments. Last, but not least, the jurisprudence on the relevant norms is often fractured and conflicting, which may again impact on a given reading. With these factors in mind, we set out below a survey of the key forms of international investment law.

4.1 OECD national treatment instrument

We will deal first with the OECD *National Treatment Instrument*. This forms part of the OECD *Declaration on International Investment and Multinational Enterprises* together with an OECD Council Decision obliging adhering countries[41] to notify their exceptions to the Instrument[42].

The OECD Instrument defines national treatment as the "commitment by a country to treat enterprises operating on its territory, but controlled by the nationals of another country, no less favourably than domestic enterprises in like situations"[43]. The exceptions to be notified are classified and encompass mechanisms like 'official aids and subsidies', 'government purchasing' and 'access to local finance'. Differential treatment of national and foreign investors concerning state aid and government procurement thus seem to be accepted by the OECD states (together with eight non-member countries) as contrary to the *National Treatment Instrument*.[44]

[41]Those forms of relief may not be used simultaneously. See footnote 35 to the *SCM Agreement*.

[42]See Art. 15 of the *SCM Agreement*; United States-Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada (WTO Doc WT/DS257/AB/R) of 19 January 2004, para 7.60.

[43] Adhering to it are the thirty OECD member countries and eleven non-member economies: Argentina (22 April 1997), Brazil (14 November 1997), Chile (3 October 1997), Egypt (11 July 2007), Estonia (20 September 2001), Israel (19 September 2002), Latvia (9 January 2004), Lithuania (20 September 2001), Peru (25 July 2008), Romania (20 April 2005) and Slovenia (22 January 2002)

[44] Although the Instrument is not binding, states have consented to a procedure of notification and negotiation of their exceptions, thus fostering transparency. The exceptions are periodically examined by the Investment Committee. These examinations result in a decision by the OECD Council, which formulates proposals for action by the country concerned. The results of the examinations are published in the series OECD *Reviews of Foreign Direct Investment*. Typically, the exceptions cover sectors like mining, transport, fisheries, broadcasting and telecommunications as well as real estate. Exceptions to national treatment cannot be found in the banking sector concerning stabilising measures, just as there are no exceptions concerning state aid for finance and automotive sectors.

With this in mind, the explicit differentiations based on nationality evident throughout Categories 1 to 3 are likely to violate the Instrument. A notification of exceptions now would also breach a standstill agreement. [45] These breaches will not give rise to justifiable disputes, as the instrument is non-binding. Investors must rely on their home countries to raise these issues in the OECD Investment Committee. The Instrument is, however, likely to have a broader impact than this initial modest output. It may well inform a common understanding of the OECD states (and the eight non-member countries) of the scope of national treatment protection, as the wording of the OECD Instrument is almost identical to many investment treaty formulations. Indeed, the Instrument has been pivotal in a number of investor-state cases in guiding the interpretative choices of arbitral tribunals, which we examine later in the chapter.[46]

4.2 Treaties of friendship, commerce, and navigation

Most modern bilateral investment treaties (BITs) are signed between developed and developing states. On first view, this typical country pairing might preclude claims by foreign investors of OECD states against other OECD countries, even though a significant proportion of global financial transactions take place within the OECD grouping. There are however two possibilities that might allow for a claim by this class of investor against an OECD state. First, an investor of an OECD state may partly structure their business operations through a developing country to take advantage of select BIT protections.[47] Second, older investment commitments – including *Friendship, Commerce, and Navigation* treaties (FCN)[48] – remain in operation across a range of OECD states. For example, the United States has FCN treaties in operation with both Germany[49] and Japan[50]. These treaties usually allow disputes to be brought before the International Court of Justice[51] and, at least in the case of the United States, may be self-executing as a matter of US constitutional law giving investors of a state party the ability to initiate claims before US courts[52]. This latter aspect may be particularly pertinent for (German and Japanese) foreign investors who are excluded from the

[45] See OECD (2008, 5).

[46] To put this slightly differently, as these measures would be a violation of the Instrument, member states would be obliged to notify them as exceptions.

[47] In 1988, a unanimous pledge of all adhering countries to refrain from introducing new exceptions ('standstill pledge').

[48] For example, see SD Myers, Inc. v Canada, UNCITRAL Award under the NAFTA (13 November 2000, at para 248; Pope & Talbot Inc v Canada, UNCITRAL Award under the NAFTA (10 April 2001), at para 78 (and footnote 73).

[49] While this is a commonly accepted strategy within the jurisprudence, it has occasionally elicited criticism by arbitral tribunals. For example, see Phoenix Action, Ltd. v Czech Republic, ICSID Case No. ARB/06/5, Award (15 April 2009).

[50] After the Second World War, the *Modern FCN Treaty Series* contained provisions on MFN status and national treatment, but also on the protection from expropriation without prompt, adequate, and effective compensation, see Paulus (2009).

[51] Signed at Washington D.C., October 29 1954, entered into force July 14 1956, available at: http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_005539.asp

[52] Signed at Tokyo April 9 1953, entered into force October 30 1953.

'Buy American' procurement conditions of the *American Recovery and Reinvestment Act* 2009 as it offers them a potential avenue of compliant within the US judicial system. The primary FCN provision involved in actions of this sort would be the obligation of national treatment[53], a norm shared with modern investment treaties. We examine that legal obligation of non-discrimination more fully in the next section.

4.3 International investment agreements

There are approximately 2800 bilateral and regional investment treaties (including investment chapters in free trade agreements) in operation across the globe.[54] The ability of an investor to initiate and conclude a claim successfully under any part of this extensive network of investment treaties will, however, depend on three key issues.

First, both the claimant and the measure in question must fall within the jurisdiction and scope of operation of the treaty instrument. On this fundamental question, we find a critical difference between US investment treaty practice and those of other states. Most US treaties – including the investment Chapter 11 of the NAFTA – exclude the provision of 'subsidies or grants' from the scope of national treatment protection.[55] In contrast, the investment treaties of other states such as Germany and the United Kingdom contain no such exclusion.[56] This would, on first view, appear to offer some protection for the United States against potential complaint by foreign investors for exclusion from the provision of US government benefits. It is important however to reiterate that this is only a limited exclusion. It does not prevent claims based on *other* provisions (such as the fair and equitable standard).

A second fundamental issue requires identification of the key substantive obligations of investment treaties that might be breached by the measures surveyed above. We examine this in sections 3(a) and (b) below and confine our analysis to two key obligations being the requirement that states accord both 'national treatment' and 'fair and equitable treatment' to foreign investors. Select and larger-scale nationalisation of shares in banks may also raise issues surrounding investment treaty guarantees of compensation in the event of expropriation.[57]

Finally, there is the issue of whether an exception might apply to shield state conduct from liability under an investment treaty. Some BITs contain carve-outs for certain sectors or explicitly allow for prudential regulation of the finance sec-

[53] As, for example *Case concerning Elettronica Sicula SpA* (ELSI) (United States of America v Italy) [1989] ICJ Rep 15.

[54] See Asakura v City of Seattle, 265 US 332 (1924), Spiess v C. Itoh & Co. (America), Inc. United States Court of Appeals Fifth Circuit [24 April 1981] 356; McKesson HBOC, Inc. v. Islamic Republic of Iran United States Court of Appeals for the District of Columbia Circuit [16 November 2001] 1107 – 8.

[55] See, for example, Art. Article XVII of the 1953 Japan-US FCN treaty.

[56] See UNCTAD (2007).

[57] North American Free Trade Agreement, Dec. 17, 1992, Can-Mex-US, 32 ILM 289 & 605, at Art. 1108(7) (b).

tor. Furthermore, some instruments contain national security clauses which might also be invoked as an exception. We examine these various but limited exceptions in Section 4.3.3 below.

4.3.1 National treatment

National treatment proscribes "less favourable treatment" of a foreign investor that stands "in like circumstances" or in "like situations" with a domestic actor.[58] Three critical interpretative questions have occupied arbitral tribunals in interpreting this obligation of non-discrimination. First, when will a foreign investor stand 'in like circumstances' or 'in like situations' with a domestic actor? Second, what will constitute 'less favourable treatment' of a foreign investor? Thirdly and perhaps most critically, is adverse purpose on the part of the regulating state required as a condition of breach and if so, what indicators should be used to evidence or construct such purpose?

As a starting point, most of the early cases – including *SD Myers v Canada* (NAFTA, 2000), *Pope & Talbot v Canada* (NAFTA, 2001), *Feldman v Mexico* (NAFTA, 2002); and *ADF v USA* (NAFTA, 2003) – endorse *some* form of competition as a condition of likeness in a national treatment inquiry. Under this line of reasoning, a foreign investor will be 'like' a competing domestic investor. This jurisprudential line is disrupted by the awards in *Occidental v Ecuador* (U.S-Ecuador BIT, 2004) and *Methanex v US* (NAFTA, 2005). The *Occidental* Tribunal adopted a much broader approach by ruling that a foreign investor involved in oil exports was 'like' domestic companies exporting non-oil related goods such as flowers and seafood products.[59] The broad *Occidental* test remains largely an outlier in the jurisprudence, with only one later case adopting other parts of that award.[60] The later *Methanex* Tribunal also opposed a role for competition in a likeness inquiry but offers a much narrower approach requiring identification of an 'identical' comparator to the foreign investor.[61] This narrow test also has not found reflection in later case law, which has largely returned to a competition-based reading of national treatment.[62]

With this in mind, we expect arbitral tribunals to adopt a robust method that looks to whether foreign investors in the finance sector as a whole are disadvantaged *vis-à-vis* competing domestic actors. It is unlikely that arbitral tribunals will endorse a narrow view that differentiates between different corporate actors (such as investment banks, wholesale banks, or other investment vehicles) simply on their organisational structure. In any event, certain laws already define the

[58] See, for example, the model German and UK BITs extracted in McLachlan et al. (2007, 379-385; and 417-422).

[59] On this point, see Calamita (2009).

[60] For a review of NT clauses in BITs, see Dolzer & Stevens (1995, 63-65). For a short survey on the meaning and jurisprudence of NT, see Dolzer and Schreuer (2008, 178 *et seqq.*).

[61] Occidental Exploration and Production Company v. Ecuador, Award, LCIA Case No UN 3467, IIC 202 (1 July 2004, para 173).

[62] Siemens A.G. v Argentina, ICSID Case No. ARB/02/8, Award (6 Feb. 2007), at paras 320-1.

type of financial sector industry[63] or the automotive sector qualifying as potential institutions for supporting measures. In those cases, foreign investors falling within the definition (but not included merely because of their nationality and (or) judicial organisation), will have a strong claim for breach. The more difficult cases involve narrowly tailored definitions such as the Swiss measure targeting only banks that pose a systemic risk to the Swiss economy. Even here, other financial institutions can make credible claims for a broad basis for comparison, since as we have seen, arbitral tribunals have looked to competitive interactions as a necessary condition of finding that domestic and foreign investors operate "in like circumstances".

The second fundamental interpretative issue involves the determination of 'less favourable treatment' of foreign investors and their investments. There is broad consensus that not only *de jure* (in law) discrimination but also *de facto* (in fact) discrimination amounts to a breach of the national treatment guarantee.[64] This is in line with WTO jurisprudence[65] and with most constitutional interpretation in different states. In other words, origin-neutral measures that pose a greater adverse burden on the foreign investor than 'like' domestic investors may be in breach of the national treatment obligation.

There are various examples of *de jure* discrimination in the measures surveyed above, not least the new Australian and Irish guarantees of retail and (or) wholesale deposits that are explicitly limited to domestic institutions. In cases involving origin-neutral measures, there is the difficult issue of determining what level of less favourable treatment of domestic investors is an appropriate requirement of breach. One possibility is that national treatment entitles a foreign investor to the best treatment afforded to like' domestic investors. If there is a single 'like' domestic actor who is treated more favourably by the regulating state, there will be 'less favourable treatment' of the foreign claimant. Under this broad approach, it is irrelevant that there may be other 'like' domestic actors who are treated equally to, or indeed worse than, the foreign claimant. This broad approach has found reflection in the jurisprudence, most notably in *Pope & Talbot v Canada* (NAFTA, 2001).[66] It has also been affirmed in successive cases, including *Methanex v US* (NAFTA, 2005)[67], parts of *UPS v Canada* (NAFTA, 2007)[68] and most recently, *ADM v Mexico* (NAFTA, 2007)[69]. If this test were to be applied, many if not all of the origin-neutral measures surveyed above are likely to constitute 'less favourable treatment' of a foreign claimant. Significant competitive advantages flow to domestic banks and institutions from these measures includ-

[63] Methanex Corporation v USA, UNCITRAL, Final Award (3 Aug. 2008), at Part IV, Chp B, para 17.

[64] Corn Products International, Inc. v Mexico, ICSID Case No. ARB(AF)/04/01, Decision on Responsibility (15 Jan. 2008), at paras. 120-122.

[65] For example Sec. 2 of the German Financial Market Stabilization Act.

[66] For example, the NAFTA Tribunal in *Feldman v Mexico* ruled clearly that "de facto difference in treatment is sufficient to establish a denial of national treatment under Article 1102". Marvin Feldman v Mexico, ICSID Case No. ARB(AF)/99/1, Award, (16 Dec. 2002), at para 169.

[67] See Horn & Mavroidis (2004); Cottier& Oesch. (2005, 383).

[68] Pope & Talbot v Canada, supra note 48, at paras 39-42.

[69] Methanex v U.S, supra note 63, at paras 20-1.

ing much lower refinancing costs through guarantees, recapitalisation, or liquidity support, and allowing supported banks to offer better interest rates than those actors which compete normally.[70]

Our third and final interpretative issue concerns the role (if any) of protectionist purpose in assessing breach of national treatment Some tribunals have held that discriminatory intent is not a necessary element for the breach of national treatment. Following the *Occidental* award[71], the *Siemens v. Argentina* Tribunal (Germany-Argentina BIT, 2007) held that "intent is not decisive or essential for a finding of discrimination, and that the impact of the measure on the investment would be the determining factor to ascertain whether it had resulted in non-discriminatory treatment"[72]. Under this effects-based approach, the mere presence of less favourable treatment of a foreign investor will be sufficient for breach. For example, the US subsidies for the 'Big Three' American automakers – which *de facto* exclude non-American car producers (except for one Toyota plant in California) – would breach the national treatment obligation of an operative investment treaty.[73]

Other awards adopt a very different approach to this interpretative question. These tribunals have explored – with different emphases – whether the distinction is based on legitimate policy grounds and justifiable, or solely as a means of conferring protection to domestic actors and thus impermissible. For example, the 2000 NAFTA *Pope & Talbot* Tribunal strongly endorses competition as a necessary condition of likeness in a national treatment inquiry[74] but also requires evidence of protectionist purpose as a condition of breach.[75] Under this competing approach, differentiation between foreign and domestic actors is permissible if rational grounds are shown for it. This may have particular relevance for interventions such as the Swiss bailout of Credit Suisse and UBS, which were publicly justified on systemic grounds. The problem however is that the investor-state ar-

[70] Arbitrator Cass ruled in his Separate Statement: "It is, as UPS urges, enough to establish that a NAFTA Party has given one or more of its investors or investments more favourable treatment". United Postal Service of America Inc. v Canada, ICSID, Award on the Merits (24 May 2007), Separate Opinion of Arbitrator Cass, at para 60.

[71] Archer Daniels Midland Company and Tate & Lyle Ingredients Americas, Inc. v Mexico, ICSID Case No. ARB(AF)/04/05, Award, at para 205.

[72] The perceived security of state guaranteed banks or bank bonds is mirrored in the spread of credit default swaps, which diminished considerably for those institutions getting help, see only Cash, Gesicherte Bankanleihen bieten attraktive Renditen of 14th May 2009, available at: http://www.cash.ch/news/newsletter/gesicherte_bankanleihen_bieten_attraktive_renditen-795407-440. See also Claessens (2009, 6).

[73] For example Occidental, supra note 61, at para 177.

[74] Siemens AG v. Argentina, Award and Separate Opinion, ICSID Case No ARB/02/8, 6 February 2007, para 321. Similarly, the NAFTA Tribunal in *Thunderbird v. Mexico* did not require the claimant to show that the less favourable treatment was motivated by nationality. See International Thunderbird Gaming Corp. v. Mexico, Award, NAFTA under UNCITRAL, January 26, 2006, para 177.

[75] Of course, the likely complainants in such an action will be German and Japanese investors in the automotive industry in the United States. However, neither Germany nor Japan has executed modern investment treaty protection with the United States. As we noted earlier however, both those states have older FCN treaties with the U.S which may be an alternate avenue of complaint. See CSR Report for Congress: *United States-Japan Economic Relations: Significance, Prospects, and Policy Options*, 9 July 2007, p. 20 et seqq., available at: http://www.fas.org/sgp/crs/row/RL32649.pdf .

bitral tribunals have not clearly defined what will constitute 'rational' grounds for differentiation. The 2004 NAFTA *GAMI* Tribunal found that the Mexican measure – nationalisation of potentially insolvent sugar refiners – did not breach national treatment because it was motivated by a legitimate public policy goal, namely keeping the sugar industry in the hands of solvent enterprises.[76] But in the *Saluka* award, the Tribunal looked at a range of different criteria in assessing the legitimacy of the exclusion of a bank with foreign shareholding from a program of state financial assistance to stabilise the Czech banking system. [77] The Tribunal surveyed criteria such as the systemic importance of the bank, its business strategy and liquidity positions.[78] It held that none of these features provided rational grounds for differentiation with domestic banks that took the benefit of the assistance program.[79] With this in mind, even those measures adopted formally for reasons of systemic concern may be in risk of breach of the national treatment obligation.

4.3.2 Fair and equitable treatment

The obligation to accord fair and equitable treatment (FET) will cover, at a minimum, three possible grounds of breach. These are: (i) discriminatory conduct on the part of a regulating host state; (ii) an absence of due process (including the failure of a state to act in a transparent manner), and (iii) denial of justice especially in offering foreign investors access to forms of judicial review.

As a starting point, the FET standard has often been held to include protection against discrimination. The Tribunal in *Eureko v. Poland* for example has linked "discriminatory conduct" with a finding of breach of the FET standard.[80] This, however, raises a fundamental interpretative issue that has largely been ignored in the jurisprudence to date. The type of discrimination caught under the FET standard must be something different to that covered by national treatment, otherwise we face the problem of redundancy. Most recent awards simply and bluntly conflate national treatment and the FET standard, where discrimination is at issue in the latter.[81] This is an untenable outcome given the need to give separate effect to each treaty provision.

In our view, the type of discrimination caught by national treatment is purposeful protectionism, defined as a desire of a host state to protect a domestic actor *vis-à-vis* a competing foreign investor. There is then the question of what

[76] Pope & Talbot, supra note 48, at para 78.

[77] Ibid. at para 79 (ruling that difference in treatment must 'be justified by showing it bears a reasonable relationship to rational policies not motivated by preference of domestic over foreign owned investments').

[78] GAMI v. Mexico, Award, NAFTA under UNCITRAL, 15 November 2004, para 114.

[79] Saluka Investments BV v. Czech Republic, Partial Award, PCA – UNCITRAL Arbitration Rules, 17 March 2006.

[80] Ibid. at para 327 *et seqq.*

[81] For example, on liquidity, the Saluka Tribunal held that it "is not convinced that different liquidity ratios warranted different treatment with regard to the provision of State financial assistance in order to overcome the bad debt problem". Ibid. at para 345.

other forms of discrimination might be caught by the FET standard. Few arbitral awards have examined this in any detail, given the tendency to conflate national treatment and the FET standard. One possibility is a type of hostile 'singling out'; the foreign investor is targeted for disadvantage by the host state simply because of their foreignness (rather than any desire to tilt the competitive scales in favour of a domestic actor).[82] If this is to be the type of discrimination caught by the FET standard, there is little evidence of hostile singling out at play in the measures we have surveyed. To put it bluntly, we are dealing with classic protectionist measures, rather than any desire to harm or evict foreign actors *per se*.

As a second possibility, the failure to act in a transparent matter in administrative decision-making has been used by arbitral tribunals to ground breach of the FET standard.[83] In *Metalclad* for instance, the Tribunal relied on a reference to transparency in part of the NAFTA in its analysis of the FET standard[84] while the *Tecmed* Tribunal drew on the notion of good faith in finding transparency to be component of the FET standard.[85] States have to some degree acted in a transparent manner in promulgating many of the emergency measures surveyed. Those measures have largely been enshrined in law (rather than simple administrative practice) and often published immediately on government websites. Nevertheless, there is still considerable uncertainty as to the eligibility of foreign actors to benefit from certain measures. For example, the US interventions do not clarify what constitutes 'substantial business activities' and whether or not foreign branches are included, or what is meant by 'government owned'.[86] It is however too early to offer a definitive assessment of breach here, given the likelihood that the executive branch will offer guidance or regulation on these different criteria.

Finally, the FET standard will be breached where foreign investors have been denied justice (usually in the domestic court systems of host states). In Germany[87] as well as in the United States,[88] special procedures have been foreseen in the emergency laws. Both countries restrict the review mechanisms usually available against state actions, but they do not entirely exclude judicial review. As there is no complete denial of due process, it is unlikely that a violation will be found on these current trends.

[82] See also Separate Opinion Wälde in Thunderbird, supra note 74, at para 103.

[83] See for example Siemens, supra note 74, at paras 318-321.

[84] We can trace a concern with this type of hostile discrimination in customary international law (which is incorporated into particular FET standards such as NAFTA Article 1105) together with intriguing hints in this direction in the decision of the ICJ Chamber in *ELSI*. See ELSI, supra note 53.

[85] Metalclad Corp. v. Mexico, ICSID Case No. ARB(AF)/97/01. See also Kotera (2008).

[86] Ibid. at para 99.

[87] Tecnicas Medioambientales TECMED S.A. v. Mexico, ICSID CASE No. ARB (AF)/00/2, para 154.

[88] Public Law 110-343, 12 USC 5202, Sec. 3: "Financial institution. – The term 'financial institution' means any institution, including, but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company, established and regulated under the laws of the United States or any State, territory, or possession of the United States, the District of Columbia, [...] and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government".

4.3.3 Exceptions

There are exceptions for host state conduct in the event of a finding of liability for breach of an obligation in an applicable investment treaty. Given the heterogeneity of this field, there are three possible categories of exemption that might apply depending on the instrument in question. First, certain newer investment treaties – especially those concluded as part of a free trade agreement – offer qualified exemption for prudential regulation of the financial services industry (modelled on the similar carve-out in the GATS)[89] or specific exemption for the application of national treatment to the financial services sector[90]. These are, on the whole, likely to offer safe harbour for state conduct otherwise in breach of an investment treaty obligation.[91] Second, certain states have amended their model bilateral investment treaty to ensure that any invocation of a treaty exemption for, *inter alia*, 'essential security interests' is a matter of competence for signatory states alone.[92] This shift towards auto-interpretation precludes any role for an adjudicator in assessing whether the constituent elements of the treaty exception have in fact been proven. In general, both these categories of exemption are relatively rare and reflect new trends in investment treaty rule-making.

In contrast, older investment treaties will only typically exempt measures 'necessary' to maintain "public order" or to protect "essential security interests".[93] This form of exemption is not explicitly self-judging and indeed has been adjudicated in a range of cases brought against Argentina in the aftermath of its 2001–2 financial crisis. We should, however, exhibit some caution in relying on this case law. Early arbitral awards – including *CMS*, *Enron,* and *Sempra* – engage in a questionable interpretative methodology of conflating the terms of the treaty exception with the stringent customary plea of necessity (represented by

[89] Sec. 15 and 16 of the *Financial Market Stabilization Act.*

[90] 12 USC 5229, Sec. 119.

[91] For example, the US-Uruguay BIT of 2006 contains a prudential carve-out in Art. 20 (1) as does Article 10(2) of the Canadian 2004 Model Foreign Investment Protection and Promotion Agreement (FIPA), Article 10 (2), available at http://www.sice.oas.org/Investment/NatLeg/Can/2004-FIPAmodel-en.pdf (accessed 7 May 2009).

[92] For example, some US BITs contain MFN/NT exceptions for the financial sector. The 1994 Argentinian-US BIT includes exceptions to national treatment in a Protocol to the BIT: "(2) With reference to Article II, paragraph 1, the United States reserves the right to make or maintain limited exceptions to national treatment in the following sectors: [...] banking; insurance [...]". The 1994 US-Bulgaria BIT and 1990 US-Turkey BIT contain similar clauses. The 1996 Ukraine-US BIT explicitly excludes financial services from MFN /NT. "The US portion of the Annex contains a list of sectors and matters in which, for legal and historical reasons, the federal government or the States may not necessarily treat investments of nationals or companies of the other Party as they do US investments or investments from a third country. The US exceptions from national treatment are: [...] banking; insurance [...]". However, none of the Swiss, the German or UK BITs contain prudential carve outs or MFN/NT exceptions for the financial service sector.

[93] A direct carve-out on national treatment in the financial services sector will exclude a claim based on national treatment, leaving only a second and possibly marginal claim on FET. If there is only a prudential carve-out, much will depend on how this carve-out is interpreted by an arbitral tribunal. As a point of comparison, the GATS prudential carve-out has not to date been interpreted by a WTO panel. See Yokoi-Arai (2008).

Article 25 of the International Law Commission's *Articles on the Responsibility of States for Internationally Wrongful Acts*).[94]

This then raises our first interpretative question of whether the effects of financial crisis might somehow engage a state's 'essential security interests'. Of the few cases that have avoided the error of conflating the treaty defence with the customary plea, the *Continental* award offers especially pertinent guidance on this question. That Tribunal was prepared to accept that the grave economic and social dislocations of the Argentine financial crisis were sufficient to engage that state's "essential security interests".[95] Ultimately however, the likely success of this defence may turn more so on whether an adjudicator will find that the particular measures chosen by the state are indeed 'necessary' to protect such 'essential security interests'. The necessity component of the treaty exception asks a question of the closeness or fit between the chosen means and the asserted regulatory purpose of the state in question. There are various methods of engaging in means-end inquiry, with the *Continental* Tribunal electing to endorse a "reasonable less restrictive means" test.[96] This approach requires an adjudicator to assess whether there are any reasonably available alternatives to the chosen measure that have less-restrictive effects on the rights of foreign investors. On the whole, it is unlikely that the current measures will fall within the exemption. It will be difficult to make the argument that discrimination directed against foreign bank institutions (with domestic depositors) was indeed 'necessary' to protect those 'essential security interests'.

Finally, one should keep in mind that most investment treaties contain a most favoured national clause (MFN). Even if the relevant treaty provision at issue restricts a possible claim by an investor, that investor may be able to use the MFN clause to invoke *more* favourable protections in other investment treaties ratified by the host state. The exceptions surveyed above, if used to shield the host state from suits concerning measures in the financial sector, might therefore be rendered obsolete through this legal manoeuvre.

5. CONCLUSION AND OUTLOOK

We draw two tentative and sobering conclusions from this analysis.

First, there is clear evidence of both overt and factual discrimination directed at foreign actors (and goods) in the laws we have surveyed. This is not confined to any individual state or select grouping; it is a marked characteristic of emergency responses to the financial crisis across a significant proportion of the globe. This then is a timely reminder to revisit the lessons associated with the outbreak

[94] See 2004 US Model BIT, Art. 13, available at http://www.ustr.gov/Trade_Sectors/Investment/Model_BIT/Section_Index.html.

[95] See for example, Art. XI of 1991 U.S-Argentine BIT.

[96] For extended analysis on this point, see Kurtz (2008).

[97] Continental Casualty Company v Argentina, ICSID Case No. ARB/03/9 (5 September 2008), at pp. 78-9.

[98] Ibid. at 87-8.

of protectionism leading to the Great Depression in the inter-war period. Protectionism is the result of a prisoner's dilemma as understood in game theory terms. Cooperation would make every state better off, but it is individually rational for states to pursue their self-interest (and protect domestic industry) at least in the short run. While protectionist instincts are now more nuanced, it is difficult to escape the conclusion that states are failing to cooperate in the current crisis, with possible cascading consequences. One pertinent example is the sharp contraction in credit availability across Eastern Europe, where much of the banking sector is controlled by Western European banks who now have strong incentives to lend only within their home countries. This leads to our second, tentative, assessment. The framers of the post-Second World War architecture of international law (especially the GATT, the forerunner of the WTO), were deeply influenced by the lessons of the inter-war period. They drafted those rules hoping to embed a loose form of cooperation and constrain the freedom of states to resort to short-term protectionist measures. The preparedness and rapidity by which states are now moving in that direction raise serious questions of whether our existing system is in fact a sufficient check against these problematic and destructive tendencies.

Ultimately however, these complex issues may be addressed – at least in the short-term – in legal rather than diplomatic *fora*. The 2001 Argentine financial crisis triggered a wave of international investment litigation against that state. There is good reason to expect foreign investors will similarly seek to use their rights under international investment law to combat discrimination embodied in state responses to the current crisis. The likely success of such litigation – with the possibility of award of significant monetary compensation – should act as some constraint against risk-averse governments continuing to resort to short-term protectionist measures.

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6

Smoke in the Water

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1. INTRODUCTION*

During the Great Depression protectionism spread rapidly. By 1933 world trade was only a third of what it was in 1929. Part of this slump had to do with the decline in economic activity, but several studies estimate the contribution of protectionist forces at somewhere between 25 to 50 percent of the total decline in world trade.[1]

The protectionist response started in the United States with the Smoot-Hawley Tariff Act passed in June 1930, which raised tariffs by 23 percent according to Irwin (1998). Many countries retaliated. According to Masden (2001), the world average effective tariff (the ratio of the value of import duties and import value) increased from 9 percent in 1929 to 20 percent by 1933, with values as high as 30 percent in Germany and the United Kingdom.

Several authors have warned of a similar – albeit more timid – trend developing as the current crisis deepens (Baldwin and Evenett, 2008; 2009; Gamberoni and Newfarmer 2009). Moreover, as suggested by Baldwin and Evenett 2009, this time protectionism may be taking murkier forms making monitoring more difficult.

An important difference between what happened during the Great Depression and today is the presence of a World Trade Organization that imposes some limits to the protectionist response.[2] One may argue that the WTO has been weakened by its failure to conclude the Doha Round it started in November 2001. However, in 1930 the only international commitment to which 1028 US-based

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[1] Irwin (1998) suggests that a quarter of the decline in US trade may be due to tariff increases associated with the Smoot-Hawley Act (part of the effective increase was due to declining prices associated with the depression in the presence of specific tariffs), whereas Masden (2001) attributes half of the decline to increases in tariff and non-tariff barriers.

[2] Bacchetta and Piermartini (2009) focus on the value of WTO's tariff bindings.

economists could refer when asking President Hoover to veto the Smoot-Hawley Act was a 1927 League of Nations resolution announcing that "the time has come to put an end to an increase in tariffs and to move in the opposite direction".[3]

The objective of this paper is threefold. First, we want to assess the extent to which countries can respond to the crisis by increasing their tariffs without violating their WTO obligations; second, to study the tariff response of countries which have been subject to economic crisis in the recent past, and finally to provide estimates of the tariff hikes we can expect in the current crisis.

2. TARIFF WATER, SMOKE, AND DEEPER WATERS

The GATT and the Agricultural Agreement of the Uruguay Round impose a legal limit to the extent of tariff hikes by WTO members. This legal limit is called a 'bound' tariff and is what is actually negotiated in the WTO.[4] The difference between the bound and the Most Favoured Nation (MFN) applied tariff measures is, in principle, the degree of flexibility available to each country within its WTO obligations. It is called 'tariff overhang' or more commonly 'tariff water'.[5]

Tariff water is generally low in the OECD's manufacturing sector but can reach very high levels in some emerging economies, or in agriculture. In order to assess the importance that the protectionist legal response can take in different countries, we estimated the average tariff water in each country or region. To do so we follow the Kee et al. (2009) aggregation methodology:

$$Water_c = \sum_{i \ni HS6} \frac{elasticity_{ic} \times imports_{ic}}{\sum_{i \ni HS6} elasticity_{ic} \times imports_{ic}} \left(B_{ic} - T_{ic}\right) \tag{1}$$

where B_{ic} is the bound tariff on good i in country c, T is the MFN applied tariff on good i in country c, imports is the value of imports on good i in country c and elasticity is the absolute value of the import demand elasticity on good i in country c. It is straightforward to see that Water is given by the difference between the weighted average bound tariff and the MFN applied tariff, where weights are given by the product of import demand elasticities and the value of imports.

Our estimates[6] suggest that the world's tariff water is 11 percent, but is close to zero in the United States and China, and higher than 70 percent in many of the least developed countries and small island states (see Table 6.1). There is also

[3] See the article on page 1 of the New York Times, May 5th 1930 : *1028 Economists ask Hoover to Veto Pending Tariff Bill.*

[4] During the Uruguay Round GATT's members agreed to bind all tariff lines for agricultural products by the end of the negotiations. Moreover, since 1989 all new members to the GATT and then to the WTO were required to bind all their tariff lines on accession. This implies that binding coverage can be incomplete only for non-agricultural products for countries that became members of the GATT before 1989.

[5] Recent studies focusing on the extent of tariff water include Archard (2008) and Boüet et Laborde (2008).

[6] Estimates are computed using observations for the latest available year, which is at best 2008.

Table 6.1: *Tariff Water (latest available year)*

Country	MFN	Bound	Water
All Countries	0.05	0.15	0.11
High Income	0.04	0.11	0.07
Middle Income	0.08	0.24	0.16
Low Income	0.09	0.45	0.36
Antigua and Barbuda	0.14	0.69	0.55
Argentina	0.08	0.36	0.28
Australia	0.03	0.10	0.07
Bahrain	0.05	0.68	0.63
Bangladesh	0.12	0.94	0.81
Barbados	0.19	0.96	0.77
Belize	0.08	0.63	0.54
Benin	0.16	0.56	0.40
Bolivia	0.08	0.45	0.36
Botswana	0.11	0.23	0.12
Brazil	0.11	0.31	0.20
Brunei	0.10	0.43	0.33
Burkina Faso	0.09	0.61	0.52
Burundi	0.13	1.04	0.91
Cambodia	0.09	0.20	0.10
Cameroon	0.14	1.07	0.93
Canada	0.03	0.09	0.06
Central African Republic	0.14	0.45	0.31
Chad	0.14	1.09	0.95
Chile	0.06	0.30	0.24
China	0.05	0.06	0.00
Colombia	0.14	0.50	0.36
Costa Rica	0.05	0.40	0.34
Cote d'Ivoire	0.11	0.51	0.40
Croatia	0.05	0.06	0.01
Dominica	0.12	0.73	0.62
Ecuador	0.10	0.25	0.15
El Salvador	0.07	0.36	0.29
European Union	0.05	0.08	0.03
Gabon	0.15	0.24	0.09
Georgia	0.01	0.08	0.07
Ghana	0.10	1.00	0.90
Grenada	0.12	0.58	0.46
Guatemala	0.07	0.44	0.37
Guinea	0.13	0.51	0.38
Guyana	0.12	0.60	0.47
Honduras	0.08	0.23	0.15
Iceland	0.02	0.26	0.24
India	0.10	0.37	0.27
Indonesia	0.06	0.35	0.28
Israel	0.04	0.36	0.32
Jamaica	0.08	0.55	0.46
Japan	0.02	0.20	0.18
Jordan	0.09	0.14	0.05
Korea, Republic	0.08	0.28	0.20
Kyrgyz Republic	0.04	0.08	0.04
Lesotho	0.15	0.66	0.50
Macedonia, FYR	0.06	0.06	0.00
Madagascar	0.11	0.60	0.49
Malawi	0.33	1.41	1.08
Malaysia	0.04	0.21	0.17
Mali	0.11	0.47	0.36
Mauritania	0.10	0.39	0.29
Mauritius	0.03	0.85	0.81
Mexico	0.13	0.39	0.25
Mongolia	0.05	0.19	0.14
Morocco	0.19	0.43	0.24
Mozambique	0.08	0.73	0.65
Myanmar	0.06	0.64	0.58
Namibia	0.09	0.33	0.24
Nepal	0.14	0.30	0.16
New Zealand	0.02	0.11	0.09
Nicaragua	0.07	0.44	0.37
Niger	0.07	0.49	0.41
Nigeria	0.08	0.78	0.70
Norway	0.01	0.11	0.10
Oman	0.05	0.13	0.08
Pakistan	0.11	0.61	0.50
Panama	0.07	0.20	0.14
Papua New Guinea	0.01	0.31	0.30
Paraguay	0.06	0.38	0.32
Peru	0.04	0.36	0.32
Philippines	0.05	0.49	0.44
Qatar	0.05	0.17	0.12
Rwanda	0.16	0.91	0.75
Saudi Arabia	0.04	0.10	0.06
Senegal	0.10	0.29	0.19
Singapore	0.00	0.65	0.65
South Africa	0.07	0.30	0.24
Sri Lanka	0.09	0.67	0.58
St. Kitts and Nevis	0.14	0.80	0.66
St. Lucia	0.10	0.87	0.77
St. Vincent	0.12	0.77	0.65
Swaziland	0.09	0.32	0.23
Taiwan	0.06	0.07	0.01
Tanzania	0.11	0.99	0.88
Thailand	0.07	0.54	0.47
Togo	0.14	1.06	0.92
Trinidad and Tobago	0.23	0.61	0.38
Tunisia	0.20	0.68	0.48
Turkey	0.06	0.48	0.43
Uganda	0.10	1.02	0.92
United States	0.03	0.03	0.00
Uruguay	0.07	0.36	0.29
Venezuela	0.14	0.36	0.22
Zimbabwe	0.10	0.63	0.52

quite significant variance across sectors with the world's agriculture tariff water at around 27 percent, whereas manufacturing tariff water is around 9 percent (see Appendix Table A6.1). Higher income levels are usually associated with lower MFN tariffs, but also with lower levels of tariff water. The average tariff water is 7 percent among high-income countries, and it doubles for middle-income countries, and doubles once again for low-income countries to reach 36 percent.

Given that on average world MFN tariffs are at around 5 percent, tariff water could potentially allow tariffs to triple without violating GATT's bound obligations. So potentially, we could have a protectionist reaction on tariff lines with positive water that is much stronger than the one observed during the Great Depression in the absence of GATT or WTO commitments. Thus, WTO tariff binding commitments would be of little value. However, a significant share of the policy space allowed by these high tariff bindings is potentially irrelevant as we discuss below.

3. SMOKE IN THE WATER AT THE OTHER END OF LAKE GENEVA[7]

There are at least two reasons why these numbers may provide an overestimate of the extent of flexibility available. First, some of the bound tariffs may be above the prohibitive tariffs, and therefore although it is legally possible to increase tariffs above their prohibitive levels it would be economically meaningless to do so. We call this 'useless water'. Second, an important share of world trade is not subject to MFN tariffs, but is regulated by preferential agreements, making tariff bounds less relevant. We call this 'deeper water', as it captures the presence of deeper commitments to lower tariffs within preferential trade agreements.

Thus, there may be a lot of tariff water available, but once we control for useless and deeper water, only a fraction offers meaningful policy space. This meaningless policy space is what we call 'smoke'. It is given by the sum of useless and deeper water.

All these concepts are formally defined below. Useless water is given by:

$$\text{Useless_Water}_c = \sum_{i \ni HS6} \frac{\text{elasticity}_{ic} \times \text{imports}_{ic}}{\sum_{i \ni HS6} \text{elasticity}_{ic} \times \text{imports}_{ic}} \max\{0; B_{ic} - P_{ic}\} \tag{2}$$

where P_{ic} is the prohibitive tariff of good i in country c. Note that useless water is bounded between 0 and Water. If useless water=water (that is $P_{ic}=T_{ic}$), then all legal flexibility granted by tariff binding is economically meaningless. If useless water=0 (that is $P_{ic} \geq B_{ic}$), then all legal flexibility is economically meaningful. The share of useless water in water determines the extent to which the legal flexibility granted by WTO agreements is economically irrelevant.

[7] The song 'Smoke on the Water' was written by Deep Purple and refers to the fire that took place at the Montreux Casino during Frank Zappa's concert in the 1971 Festival. Montreux is at the opposite end of Lake Geneva from the WTO.

A problem with equation (2) is the determination of prohibitive tariffs. To calculate them we use a linear approximation around the equilibrium imports in each country. Start with the definition of the import demand elasticity, and note that a prohibitive tariff implies m_i=-m_i. Then solve for the prohibitive tariff recalling that the domestic price is given by :

$$P_{ic} = T_{ic} + \frac{1+T_{ic}}{\text{elasticity}_{ic}} \tag{3}$$

Thus the prohibitive tariff can be readily calculated using estimates of import demand elasticity at the six-digit level of the Harmonized System for more than 100 countries in Kee et al (2008). They are then replaced in (2) to obtain a measure of useless water.

As mentioned earlier, preferential trade also makes bound tariffs and water less relevant. To see this, simply note that as the MFN tariff increases, preferential trade is unaffected. If anything, it increases. At the limit, if all trade is preferential, then an increase in the MFN applied tariff to the bound or prohibitive level is meaningless.

We suggest two corrections for this. First, the distribution of preferential imports across goods and its correlation with bound, applied, and prohibitive tariffs matters. Thus the weights used in the weighted average need to take this into account. The idea is that if imports of good i are exclusively preferential, then the difference between bounds or prohibitive tariffs on the one hand, and MFN tariffs on the other hand is irrelevant when it comes to measuring the extent of flexibility available in the system. It is all deeper water that is beyond the legal scope of the WTO. Deeper water is then formally defined as:

$$\text{Deeper water}_c = \sum_{i \ni HS6} \frac{\text{elasticity}_{ic} \times \text{imports}_{ic}}{\sum_{i \ni HS6} \text{elasticity}_{ic} \times \text{imports}_{ic}} \left(\min\left(B_{ic}; P_{ic}\right) - T_{ic}\right) \frac{\text{imports}_{ic}^{pref}}{\text{imports}_{ic}} \tag{4}$$

where are preferential imports of good i by country c.

Finally, we define smoke as the sum of useless and deeper water:

$$\sum_{i \ni HS6} \frac{\text{elasticity}_{ic} \times \text{imports}_{ic}}{\sum_{i \ni HS6} \text{elasticity}_{ic} \times \text{imports}_{ic}} \left[\max\left(0; B_{ic} - P_{ic}\right) + \left(\min\left\{B_{ic}; P_{ic}\right\} - T_{ic}\right) \frac{\text{imports}_{ic}^{pref}}{\text{imports}_{ic}}\right] \tag{5}$$

Figure 6.1 illustrates the concepts we have introduced. Water is given by the difference between bound and MFN tariffs. Useless water is given by the share of water between the bound and the prohibitive tariff. Deeper water is the share of the remaining water that is subject to preferential trade. What is left is called policy space.

Our estimates of the share of useless water, deeper water and smoke in total water are reported in Table 6.2. They suggest that around 28 percent of the world's

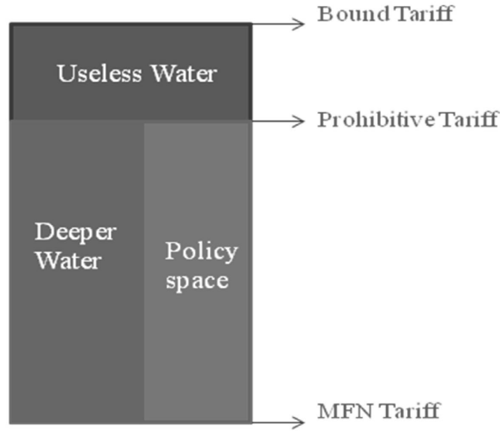

Figure 6.1: *From Water to Policy Space*

tariff water is smoke, and therefore does not represent truly available policy space. Around 75 percent of this is due to useless water (bounds above their prohibitive levels), and the remaining 25 percent due to deeper water (the presence of preferential trade). The prominence of useless water is particularly noticeable among low-income and high-income countries, where it represents close to 90 percent of smoke. Deeper water represents more than 60 percent of smoke in middle-income countries.

There are also some interesting differences across sectors. Around 67 percent of agriculture's tariff water is smoke, but only 18 percent in manufacturing. This suggests that there are some economic limits to the protectionist response in agriculture.

There are also striking differences across countries. Smoke represents less than 5 percent of tariff water in Benin, Botswana, China, Ghana, Guinea-Bissau, Macedonia, Chad, Thailand, and Uganda, but it is more than 50 percent of tariff water in Australia, Chile, the European Union, Cambodia, Mexico, Namibia, Norway, Venezuela, and Zimbabwe.

In any case, the economic irrelevance of tariff water due to the presence of smoke does not constrain in an economically significant way the protectionist response allowed by GATT's bindings. On average the remaining policy space still represents 62 percent of tariff water. And given that tariff water is about twice the existing levels of MFN protection, there is enough policy space left to more than double MFN protection.

Table 6.2: *Share of Deeper Water, Useless Water, and Smoke in Water (latest available year)*

Country	Deeper	Useless	Smoke
All countries	11.4	20.0	31.4
High Income	5.7	22.6	28.2
Middle Income	23.9	12.6	36.6
Low Income	3.1	27.2	30.2
Antigua and Barbuda	13.6	7.6	21.3
Argentina	21.0	22.8	43.8
Australia	39.7	21.0	60.8
Bahrain	7.4	1.1	8.5
Bangladesh	4.9	23.0	27.9
Barbados	8.7	22.0	30.7
Belize	29.5	4.8	34.2
Benin	4.9	0.5	5.4
Bolivia	43.7	6.6	50.2
Botswana	10.3	1.1	11.4
Brazil	16.4	30.5	46.8
Brunei	21.8	8.7	30.5
Burkina Faso	5.7	3.6	9.3
Burundi	46.7	3.2	49.9
Cambodia	14.0	38.7	52.7
Cameroon	4.7	1.4	6.1
Canada	17.5	5.3	22.7
Central African Republic	0.1	1.3	1.3
Chad	0.2	1.2	1.4
Chile	56.0	7.4	63.4
China	4.7	0.3	5.0
Colombia	18.8	22.0	40.9
Costa Rica	2.1	17.9	20.0
Cote d'Ivoire	1.0	1.0	1.9
Croatia	24.3	0.2	24.6
Cuba	11.2	6.1	17.3
Dominica	36.1	4.8	40.9
Ecuador	21.3	1.2	22.5
El Salvador	12.1	18.8	30.9
European Union	11.9	41.7	53.6
Gabon	3.9	5.9	9.9
Georgia	5.5	5.3	10.8
Ghana	0.3	0.8	1.1
Grenada	21.9	4.5	26.4
Guatemala	13.7	20.0	33.7
Guinea-Bissau	0.0	0.1	0.1
Guyana	38.9	14.5	53.4
Honduras	18.0	2.0	20.1
Iceland	16.0	3.4	19.4
India	0.2	39.9	40.1
Indonesia	4.8	21.6	26.4
Israel	20.0	8.4	28.3
Jamaica	12.9	12.0	25.0
Japan	0.1	41.1	41.2
Jordan	23.8	1.1	24.9
Korea, Rep.	6.2	2.5	8.7
Kyrgyz Republic	52.2	0.0	52.2
Lesotho	1.1	11.0	12.1
Macedonia, FYR	2.4	0.0	2.4
Madagascar	12.2	0.2	12.4
Malawi	40.9	2.3	43.1
Malaysia	17.1	16.6	33.6
Mali	6.8	1.1	7.9
Mauritania	0.0	46.7	46.7
Mauritius	8.9	4.5	13.4
Mexico	54.6	14.0	68.6
Mongolia	0.0	0.3	0.3
Morocco	34.7	14.8	49.4
Mozambique	7.2	23.5	30.7
Myanmar	11.3	29.4	40.6
Namibia	48.5	3.5	52.0
Nepal	6.8	5.3	12.2
New Zealand	37.3	13.8	51.0
Nicaragua	12.6	7.3	20.0
Niger	2.3	13.4	15.7
Nigeria	0.5	11.8	12.3
Norway	4.8	64.8	69.5
Oman	24.5	8.6	33.1
Pakistan	2.5	34.9	37.4
Panama	29.2	3.6	32.8
Papua New Guinea	0.2	5.3	5.5
Paraguay	33.0	2.4	35.4
Peru	18.3	28.0	46.2
Philippines	14.8	1.9	16.7
Qatar	14.8	9.7	24.5
Rwanda	14.2	28.9	43.0
Saudi Arabia	7.2	5.5	12.7
Senegal	0.5	14.7	15.2
Singapore	0.0	4.4	4.4
South Africa	8.7	13.6	22.3
Sri Lanka	14.9	0.5	15.4
St Kitts and Nevis	12.5	5.6	18.1
St Lucia	26.3	22.2	48.5
St Vincent and Grenadines	23.0	7.0	30.0
Swaziland	0.1	29.2	29.3
Taiwan	0.3	4.4	4.7
Tanzania	11.9	2.1	14.0
Thailand	0.1	1.4	1.5
Togo	2.0	0.2	2.2
Trinidad and Tobago	1.7	6.4	8.1
Tunisia	12.7	0.9	13.6
Turkey	36.3	2.9	39.2
Uganda	5.6	0.4	6.1
United States	4.9	21.4	26.2
Uruguay	42.6	12.1	54.8
Venezuela, RB	19.9	36.1	56.0
Zimbabwe	39.7	19.8	59.5

4. ASSESSING THE PROTECTIONIST RESPONSE IN PREVIOUS CRISIS

One important step on our way to assessing the protectionist response during the current crisis is to look back and measure the protectionist response in previous crises (see also Eichengreen and Irwin, 2009). We concentrate ourselves on the recent past, with an *a priori* that the creation of the WTO at the end of the Uruguay Round may have changed the scope for protectionist responses for member countries.[8]

Thus, our sample spans from 1995 to 2008 and it includes all countries reported in Tables 1 and 2. We identify economic crisis as an annual decline in real GDP. During the period we have on average 18 countries that suffer an economic crisis every year (this corresponds also to 18 percent of the countries in our sample). In the mid 2000s the number of economic crises every year dropped to five. It increased to 12 in 2008, and according to the Economist Intelligent Unit's predictions it will affect 71 countries of our sample in 2009. The worst year between 1995 and 2008 in terms of economic crisis is 1999, where 36 countries out of 97 suffered an economic crisis.

The equation to be estimated is given by:

$$\ln(t_{ict}) = \alpha_{ic} + \alpha_t + \beta_1 Crisis_{ct} + \varepsilon_{ict} \tag{6}$$

where is the impact of the crisis on log of MFN tariffs. With this semi-log specification, is the percentage change in MFN tariffs during an economic crisis. We also try different specifications where we control for the size of the country (GDP), as well as the share of neighbours that are in an economic crisis according to our definition. Our preferred specification also includes an interaction between crisis on the one hand, and economic size and the share of neighbours in an economic crisis to try to capture any potential heterogeneity. It is given by:

$$\begin{aligned} \ln(t_{ict}) = {} & \alpha_{ic} + \alpha_t + \beta_1 Crisis_{ct} + \beta_2 Neigh_{ct} + \beta_3 \ln(GDP)_{ct} \\ & + \beta_4 \ln(GDP)_{ct} * Crisis_{ct} + \beta_5 \ln Neigh_{ct} * Crisis_{ct} + \varepsilon_{ict} \end{aligned} \tag{7}$$

where Neigb is the share in GDP of the 10 closest neighbours of country c that had a crisis in year t.[9]

Results are reported in Table 6.3. The first column suggests that an economic crisis increases MFN tariffs on average by 2.0 percent. After controlling for the

[8] One could test this hypothesis using earlier data, but tariff line data are only available for a few countries before 1995.

[9] Other sources of heterogeneity are also possible. For example Eichengreen and Irwin (2009) suggest that countries with a fixed exchange rate regime (and perfect capital mobility) are more likely to resort to a protectionist response during an economic crisis. The severity of the crisis may also matter. And therefore we could check for different types of economic crisis (for example declines in real GDP of more than 2 percentage points).

size of the country (large countries tend to have smaller tariffs), and the share of neighbours that are also in an economic crisis in the second column, the coefficient on crisis increases to 2.2 percent. In the third column we introduce the interaction term between crisis and size, and we obtain a positive coefficient on the interaction term, signalling that large countries are more likely to increase their tariffs than small countries are.[10] Note that the coefficient on crisis becomes negative, but the full derivative with respect to crisis that takes into account the interaction term is never negative, and oscillates between 0 and 7 percent in the sample. It is equal to 3.2 percent at the mean of the sample.

Table 6.3: *Protectionist Responses during Economic Crisis*

	Log MFN (1)	Log MFN (2)	Log MFN (3)	Log MFN (4)	Log MFN (5)	Log MFN (6)	*Log MFN (7)*	Log MFN (8)	Log MFN (9)	Log MFN (10)
Crisis	.0195	.022	−.114	−.089	.020	0.013	.016	−.111	−.111	−.082
	(.001)a	(.001)a	(.010)a	(.011)a	(.001)a	(0.003)a	(0.06)	(.011)a	(.011)a	(.011)a
LGDP		−.060	−.059	−.059				−.059	−.059	−.059
		(.001)a	(.001)a	(.001)a				(.001)a	(.001)a	(.001)a
LGDP*Crisis			.006	.005				.006	.006	.005
			(.001)a	(.001)a				(.001)a	(.001)a	(.001)a
Neigh		−.060		.058						−.059
		(.001)a		(.001)a						(.001)a
Neigh*crisis				.001						.001
				(.004)						(.004)
Lag Crisis					−.0245					
					(.001)a					
Interme*Crisis								−.006		−.006
								(.002)a		(.002)b
Water*Crisis									−.002	−.002
									(.001)	(.001)
Observations	3455453	3455453	3455453	3455453	3455500	3455453	770	3455453	3455453	3455453
Adjusted R2	0.873	0.873	0.873	0.873	0.873	0.873	0.858	0.873	0.873	0.873

Standard errors are in parenthesis and are corrected for clustering across products and countries. a for $p < 0.01$, b for $p < 0.05$ and c stands for $p < 0.10$. All regressions include countryxproduct fixed effects, as well as year dummies.

Finally, in the fourth column we report the results of our preferred specification corresponding to equation (7) above. The coefficient on crisis is negative, but again after taking into account the interaction term with log of GDP, we have that the derivative of MFN tariffs with respect to crisis is always positive. At the mean of the sample the increase in MFN tariffs is 3.1 percent, and for the country with the largest GDP the increase is equal to 6.1 percent, and 0.6 percent for the smallest country. An additional interesting result is that if all 10 neighbouring countries also get into an economic crisis (Share_Neighb=1), then the MFN tariff

[10] This may be because small countries are more likely to be under a strict structural adjustment program, and this is something that could be tested.

increases on average by 5.8 percent. The interaction between the share of neighbours in a crisis and the country itself having a crisis is quantitatively very small and is not statistically different from zero.

We also perform some robustness checks. Our results so far suggest that from 1995 up to 2008 increases in MFN tariffs during economic crisis have been modest, especially in small countries. The fifth column checks whether they have also been long lived, by introducing a lagged crisis variable. We obtain again that countries increase their tariff on average by 2 percent during the economic crisis, but that one year later this is reversed. This regression (column 5) also implicitly addresses the potential problem of endogeneity or reverse causality. Indeed, tariffs are not always higher in countries that are more subject to crisis, but they seem to rise in the year of the crisis, and decline one year later.

In column (6) we use an alternative definition of crisis to check for the robustness of the results. One may argue that in deep crisis protectionism responses will be stronger. Thus, in column (6) crisis is defined as a fall in real GDP of more than 3 percent. The results suggest again an increase in protectionism. Perhaps surprisingly, the protectionism increase during strong recessions is smaller than in the presence of shallow recessions (although they are not statistically different from each other). Maybe countries in deep recessions are more likely to take the opportunity to engage in deeper institutional and policy reforms that will prevent large increases in protectionism.

Column (7) reports results using group averages, and weighted least squares, where weights are given by group size. Indeed, given that crisis does not vary across products, the error can be correlated across HS6-digit lines within a country every year. Our previous standard error estimates are all corrected non-parametrically for the correlation in the error term within groups, and we have a sufficiently large number of clusters to ensure the asymptotic properties of this correction. Nevertheless we provide weighted least squares estimates using group averages as a robustness check. Column (7) provides results for the specification in column (1). The estimated increase in tariff is not statistically different from the one estimated in column (1), but it is not statistically different from zero either, suggesting that the increase can potentially be much lower than suggested in our previous estimates where we may have underestimated the variance of these estimates.

We explore two additional sources of response heterogeneity.[11] First, in a world where a growing share of trade is undertaken in intermediate goods, one may expect the protectionist response to be smaller in intermediate goods. This is checked in column (9) where we introduced the interaction between crisis and a dummy that takes the value 1 when the good is not a final consumption good (this dummy does not enter the regression by itself because it is perfectly collinear with our country*product fixed effects). The interaction term is negative and statistically significant as expected.

[11] We are grateful to Bernard Hoekman and Hakan Nordstrom for suggesting these additional checks to us.

Second, one may expect that the protectionist response depends on how much policy space is available, so we also introduce an interaction term between crisis and tariff water after correcting for smoke in column 9. The coefficient is small, negative, and statistically insignificant, so policy space does not seem to be the constraint on countries' protectionist response.[12] The last column introduces all these interaction terms together.

5. ESTIMATING THE 2009 PROTECTIONIST RESPONSE: FIRE IN THE SKY?

We use the estimates reported in the fourth column of Table 6.3 to predict the percentage increases in MFN tariffs by country during the year 2009. GDP growth estimates are from the Economist Intelligence Unit.

Results are reported in Table 6.4. On average the economic crisis results in an increase in MFN tariffs of 8 percent. The smallest increase will occur in the Kyrgyz Republic and Togo with a moderate 1.1 percent increase in MFN tariffs. Note that of the 10 countries with the lowest increase in protectionism, nine are located in Sub Saharan Africa SSA. The low increase in protectionism is partly explained by their small economic size, and the fact that a small share of their neighbours is predicted to be in an economic crisis.

At the other end of the scale, we predict an increase in MFN tariff of around 10 percent in the United States, Canada, and Australia. Note however, that these are countries with very low MFN tariffs so the 10 percent increase will only lead to a moderate increase in absolute levels of protectionism. Moreover, for those countries water appears only in a limited number of tariff lines. The predicted increase in MFN tariffs is 8.3 percent in the European Union. Figure 6.2 plots the predicted percentage change in MFN tariffs against the log of GDP per capita.

6 CONCLUDING REMARKS

The amount of policy space left by WTO legal tariff bindings allows for an increase in MFN tariffs similar to what we observed during the Great Depression and this is after controlling for the smoke in the tariff water, that is, bindings above prohibitive levels and widespread regional trade agreements.

However, when looking at the recent economic crisis, it seems that this large policy space has been rarely used by countries facing economic crisis. Large countries tend to increase their tariffs more than small countries when facing a crisis, and even more when the crisis also affects neighbouring countries. Increases in intermediate goods tariffs tend to be smaller than increases in final goods tariffs as one would expect in a world with a growing share of trade in intermediate goods. Also, tariff increases do not seem to be constrained by the available policy space. Nevertheless, the overall increase in MFN tariffs remains modest.

[12] Policy space does not enter the regression by itself because we only have it available for 2008 tariffs, and therefore it is perfectly correlated with the country*product fixed effects.

Table 6.4: *Predicting MFN Tariff Changes in 2009*

Country	MFN Tariff	EIU forecast GDP growth 2009 (%)	Share of Neighbours with forecasted crisis	Predicted Effect on MFN (%)
All countries	0.05	−2.5	52.6	8.0
High Income	0.04	−4.3	64.7	8.3
Middle Income	0.08	1.7	25.4	5.8
Low Income	0.09	2.6	2.9	3.5
Argentina	0.08	−2.8	82.0	8.5
Australia	0.03	−1.2	100.0	9.7
Bahrain	0.05	2.4	22.5	3.3
Banglad.	0.12	5.5	0.0	2.8
Belize	0.08	1.5	91.2	6.3
Benin	0.16	2.2	1.2	1.4
Bolivia	0.08	1.4	87.2	7.1
Botswana	0.11	0.2	84.8	6.8
Brazil	0.11	−1.5	63.3	7.7
Cambodia	0.09	−3.0	0.0	1.7
Canada	0.03	−2.2	99.2	9.9
Chad	0.14	−1.0	0.0	1.3
Chile	0.06	0.4	92.7	8.5
China	0.05	6.0	0.0	4.5
Colombia	0.14	−3.0	65.3	6.9
Costa Rica	0.05	−0.8	69.2	6.4
Cote d'Ivoire	0.11	3.0	1.1	2.0
Croatia	0.05	−1.8	82.7	7.2
Ecuador	0.10	−3.5	71.4	6.5
El Salvador	0.07	1.0	92.6	7.6
EU	0.05	−3.8	76.0	8.3
Gabon	0.15	2.8	1.2	1.7
Georgia	0.01	0.5	46.9	4.4
Ghana	0.10	5.2	1.0	1.8
Guatemala	0.07	1.2	93.6	7.8
Guyana	0.12	1.8	75.5	5.2
Honduras	0.08	−0.3	91.1	7.3
Iceland	0.02	−12.4	99.2	7.8
India	0.10	5.0	0.0	4.0
Indonesia	0.06	−1.3	0.0	3.4
Israel	0.04	0.1	51.6	6.2
Jamaica	0.08	−3.8	78.1	6.5
Japan	0.02	−6.4	0.0	4.9
Jordan	0.09	3.5	46.0	4.7
Korea, Rep.	0.08	−10.1	0.0	3.9
Kyrgyz Rep.	0.04	1.0	0.0	1.1
Lesotho	0.15	0.40	81.1	5.6
Macedonia, FYR	0.06	1.0	69.0	5.5
Madagascar	0.11	4.2	1.9	1.7
Malawi	0.33	8.2	1.8	1.3
Malaysia	0.04	−3.0	0.0	3.1
Mauritius	0.03	2.2	2.0	1.8
Mexico	0.13	−2.6	67.8	7.9
Morocco	0.19	2.3	71.9	6.9
Mozambique	0.08	4.8	81.6	6.6
Myanmar	0.06	0.3	52.3	8.1
Namibia	0.09	0.8	81.9	6.4
New Zealand	0.02	−3.2	97.9	8.5
Nicaragua	0.07	1.2	91.6	7.0
Niger	0.07	2.7	2.0	1.3
Nigeria	0.08	2.7	1.6	2.9
Norway	0.01	−1.2	79.2	8.0
Oman	0.05	2.5	0.0	2.3
Pakistan	0.11	1.0	0.0	3.0
Panama	0.07	−1.3	88.0	7.3
Papua New. Guinea	0.01	−0.5	100.0	7.4
Paraguay	0.06	−3.1	84.3	6.8
Peru	0.04	3.0	73.9	7.2
Philippines	0.05	−0.6	0.0	3.0
Qatar	0.05	10.8	23.0	4.4
Rwanda	0.16	5.5	7.8	1.7
Saudi Arabia	0.04	0.4	26.1	5.0
Senegal	0.10	3.5	1.0	1.7
Singapore	0.00	−7.5	0.0	3.1
South Africa	0.07	−1.6	2.1	3.4
Sri Lanka	0.09	2.6	0.0	2.3
Swaziland	0.09	0.3	81.4	5.8
Taiwan	0.06	−9.3	0.0	5.4
Tanzania	0.11	4.5	2.2	2.2
Thailand	0.07	−4.4	0.0	3.3
Togo	0.14	3.0	1.0	1.1
Trinidad Tobago	0.23	0.9	88.3	7.3
Tunisia	0.20	2.4	73.4	6.7
Turkey	0.06	−2.0	59.8	7.2
Uganda	0.10	4.0	9.5	2.4
United States	0.03	−3.1	95.4	10.9
Uruguay	0.07	−0.2	84.2	7.3
Zimbabwe	0.10	−4.7	0.0	1.6

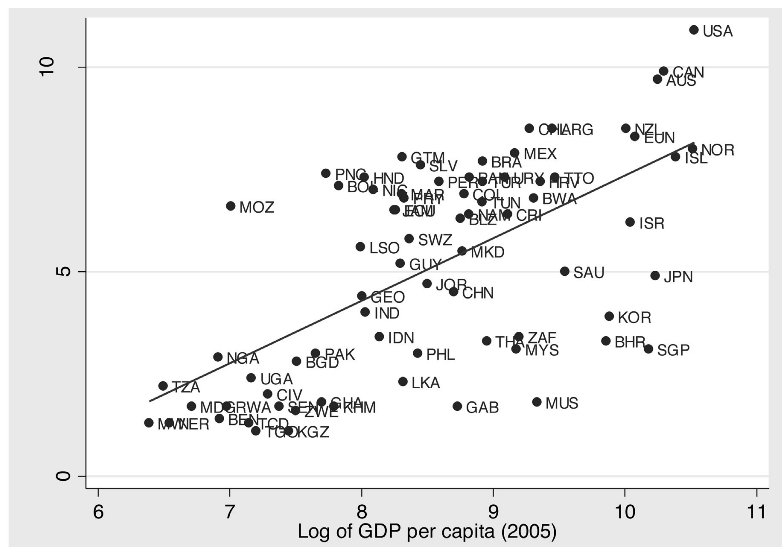

Figure 6.2: *Predicted Change in MFN Tariffs*

Using these estimates for the period 1995–2008, we then predict the increases in MFN tariffs to be observed in 2009 depending on whether the country faces an economic crisis and the share of neighbours predicted to have an economic crisis. MFN tariff hikes oscillate between 1 and 10 percent, with the largest percentage increases in countries with relatively low levels of MFN tariffs in 2008.

Obviously, MFN tariffs are only one of many instruments in the protectionist toolbox. Baldwin and Evenett (2009) warned us of the increase in the use of murkier forms of protectionism such as during the Great Depression, and a similar study on the evolution of other forms of protectionism is needed.

This will help us understand why countries are not using the policy space available during economic crisis. If it is the simple recognition that protectionism may not be the right response and that it can exacerbate the problem it is trying to correct, then we should not be observing increases in murkier forms of protectionism. However, if the reason has to do with country reputation and fear of signalling beggar-thy-neighbour behaviour to other countries, then increases in murkier and less transparent forms of protectionism are consistent with the smallest increases in MFN tariffs.

Hopefully the first explanation is the correct one; but if murkier and less transparent forms of protectionism are spreading, then an adequate response by the international community would be to bring more transparency to the system.

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APPENDIX 1: DATA SOURCES AND VARIABLE DESCRIPTION

All data on MFN, PTA and bound tariffs as well as import values are from the World Integrated Trade Solution (WITS) based on the Trade Analysis and Information System (TRAINS). European Union data are only for extra-EU trade. The data on past GDP come from the World Bank's World Development Indicators. The 2009 forecasts of the GDP indicators are made by the Economist Intelligence Unit in their country's Analysis and Forecast section. The data on geodistances come from the CEPII research centre.

The cross-section contains MFN and bound tariffs at HS-6 level, import values and GDP per capita for 97(TBC) countries as well as for five regional aggregates, three income-level aggregates and an overall average of all countries. For all except GDP per capita, the data are from the latest available year in TRAINS, while data for the GDP per capita for the year 2005 were used because they contain the least missing values.

The time series data set runs from 1995 to 2008 and counts with yearly MFN and bound tariff at HS-6 level with each country as reporter and the world as partner, plus real GDP measures. Bilateral distance is used to identify the closest neighbours of each country.

Products under Preferential Trade Agreements (PTA) are those where the difference between the MFN tariff and effectively applied tariff is larger than 0.1 percent (to account for any rounding error). In this way each tariff line is labelled as having a PTA or not; the trade values are then aggregated for each country separately according to lines that are PTA and lines that are not under PTA.

When the bound tariff is smaller than the MFN, the bound was replaced by the MFN (17999 cases out of 477083 observations). In the case of an unbounded tariff line, the bound tariff is calculated by using the prohibitive tariff. In the data used in section 2, this occurred in 101761 tariff lines out of 477083 observations.

The crisis dummy captures a negative GDP growth (as recorded in the WDI), thus implying a year-to-year decline in GDP (in real terms).

The variable capturing crisis in neighbouring countries is calculated as the share of crisis dummies in the closest 10 neighbouring countries weighted by their GDP. (The partner's GDP are used to weight both their distances from the country in order to rank the closest neighbours taking account of their economic size, and also when taking the share of crisis dummies of these 10 neighbours).

APPENDIX TABLE A6.1

	Agriculture		Manufacturing	
Country	Smoke Water	Water	Smoke/ Water	Water
All countries	70.5	0.26	21.3	0.09
High Income	75.7	0.24	7.8	0.05
Middle Income	62.3	0.23	33.2	0.16
Low Income	52.1	0.72	27.1	0.33
Antigua & Barbuda	26.4	0.96	17.7	0.43
Argentina	83.3	0.24	42.1	0.28
Australia	62.0	0.05	60.7	0.07
Bahrain	33.3	0.36	7.9	0.64
Bangladesh	57.7	1.85	17.2	0.68
Barbados	28.5	0.74	31.3	0.78
Belize	5.6	0.89	41.9	0.49
Benin	7.0	0.47	5.1	0.39
Bolivia	86.7	0.30	46.4	0.37
Botswana	33.8	0.24	10.5	0.12
Brazil	86.8	0.31	40.8	0.19
Brunei	19.2	0.37	32.1	0.32
Burkina Faso	24.0	0.78	4.6	0.47
Burundi	62.4	0.75	48.2	0.93
Cambodia	68.9	0.30	30.7	0.06
Cameroon	14.0	0.71	4.8	0.98
Canada	52.8	0.07	19.0	0.06
Central African Rep.	1.6	0.12	1.3	0.35
Chad	13.2	0.60	0.2	1.01
Chile	91.4	0.23	60.4	0.24
China	18.5	0.00	4.8	0.00
Colombia	67.2	1.01	30.4	0.29
Costa Rica	31.0	0.23	19.2	0.36
Cote d'Ivoire	16.1	0.14	0.8	0.47
Croatia	25.8	0.03	24.2	0.01
Cuba	38.3	0.23	10.4	0.37
Dominica	41.7	1.01	40.5	0.52
Ecuador	40.1	0.16	19.6	0.15
El Salvador	45.6	0.29	28.0	0.29
European Union	65.6	0.23	24.8	0.01
Gabon	14.6	0.38	1.6	0.04
Georgia	31.4	0.08	5.6	0.07
Ghana	8.0	0.76	0.2	0.92
Grenada	35.1	0.70	22.4	0.40
Guatemala	46.1	0.57	31.3	0.35
Guinea	0.3	0.30	0.0	0.40
Guyana	55.7	0.71	52.4	0.42
Honduras	33.0	0.17	17.6	0.15
Iceland	28.3	0.31	18.5	0.23
India	73.4	0.68	38.0	0.26
Indonesia	42.0	0.43	24.5	0.27
Israel	48.0	0.65	23.8	0.29
Jamaica	26.1	0.74	24.6	0.41
Japan	88.4	0.70	0.1	0.11
Jordan	17.4	0.05	26.2	0.05
Korea, Rep.	40.1	0.15	6.9	0.21

	Agriculture		Manufacturing	
Country	Smoke/ Water	Water	Smoke/ Water	Water
Kyrgyz Republic	60.0	0.07	48.8	0.03
Lesotho	46.7	1.93	7.2	0.46
Macedonia, FYR	16.2	0.00	1.4	0.00
Madagascar	19.9	0.34	11.8	0.51
Malawi	56.2	0.88	41.0	1.12
Malaysia	75.8	0.61	20.5	0.14
Mali	17.2	0.44	5.8	0.35
Mauritania	67.3	0.46	2.7	0.17
Mauritius	29.8	0.92	8.7	0.79
Mexico	91.1	0.26	65.7	0.25
Mongolia	1.6	0.13	0.1	0.14
Morocco	36.3	0.47	53.1	0.21
Mozambique	64.0	0.87	9.0	0.56
Myanmar	90.0	1.60	9.9	0.42
Namibia	85.7	0.41	40.9	0.21
Nepal	16.2	0.32	9.8	0.12
New Zealand	72.2	0.05	49.2	0.09
Nicaragua	58.1	0.40	10.5	0.36
Niger	48.7	0.83	9.5	0.38
Nigeria	34.7	1.13	5.1	0.63
Norway	84.4	0.66	3.9	0.02
Oman	33.8	0.11	33.1	0.08
Pakistan	56.9	1.04	35.3	0.47
Panama	18.1	0.09	34.0	0.14
Papua N. Guinea	7.5	0.26	5.1	0.31
Paraguay	89.8	0.17	33.4	0.33
Peru	73.3	0.35	35.5	0.31
Philippines	25.2	0.40	15.7	0.44
Qatar	37.7	0.16	22.9	0.12
Rwanda	39.3	0.40	43.3	0.80
Saudi Arabia	12.7	0.11	12.7	0.05
Senegal	3.4	0.16	17.2	0.20
Singapore	75.0	1.05	0.0	0.64
South Africa	46.2	0.36	19.7	0.23
Sri Lanka	13.4	0.30	15.5	0.63
St Kitts and Nevis	24.5	0.87	15.9	0.61
St Lucia	40.6	1.03	51.1	0.71
St Vincent and Grenadines	36.2	1.04	26.3	0.53
Swaziland	17.6	0.34	31.0	0.22
Taiwan	39.5	0.02	0.2	0.01
Tanzania	30.7	0.91	12.0	0.87
Thailand	14.6	0.34	0.9	0.47
Togo	13.3	0.66	1.7	0.93
Trinidad Tobago	13.7	0.62	7.2	0.36
Tunisia	17.2	0.44	13.3	0.49
Turkey	44.2	0.22	38.9	0.45
Uganda	18.3	0.57	5.3	0.96
United States	43.5	0.01	6.0	0.00
Uruguay	86.3	0.25	51.6	0.29
Venezuela	65.2	0.46	53.9	0.20
Zimbabwe	85.6	1.20	48.3	0.42

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7

The Global Resort to Antidumping, Safeguards, and other Trade Remedies Amidst the Economic Crisis

CHAD P. BOWN

1. INTRODUCTION

World Trade Organization member countries turn to import-restricting 'trade remedy' instruments during both good and bad macroeconomic times. Nevertheless, the historical economic evidence finds a strong link between economic downturns associated with recessions and exchange rate shocks, and an *increase* in the use of policies such as antidumping and safeguards. The sudden onset and global nature of the current economic crisis have created concern that countries may dramatically increase their use of such trade remedy instruments beyond the 'normal' underlying current of protectionism associated with the ongoing process of adjustment, that is associated with the forces of globalisation.

Section 2 of this paper examines newly available data tracking the global use of these trade remedy instruments which do indicate a marked increase in WTO members' combined resort to these instruments beginning in 2008, and that continued into the first quarter of 2009 during the spread of the global economic crisis. The product-level use of trade remedies was 34 percent higher in 2008 relative to 2007, and use in the first quarter of 2009 was 22.3 percent higher than in the same period in 2008. The imposition of new definitive measures in 2009 is projected to be 18.5 percent higher than the number imposed in 2008.

A number of countries have resorted to these instruments, including almost all of the Group of Twenty (G20) that are members of the WTO. These countries have few alternatives for invoking new forms of potentially WTO-consistent import protection, as many are constrained both by the rules of the international system and because their pre-crisis applied tariff rates may have been somewhat close to their tariff bindings legally submitted to the WTO. The use of these import-restricting instruments is increasingly affecting 'South-South' trade; that is, developing country importers initiating and imposing new protectionist measures primarily affecting developing country exporters. The majority of the product-level actions to limit import competition intensively target exports from China.

Despite the increasing use of these instruments the quantity of imports targeted by these measures thus far is relatively small. Collectively, the value of imports in 2007 for these major G20 economies that has subsequently come under attack by the use of import-restricting trade remedies during the period of 2008 to early 2009 is likely to be less than $29 billion, or less than 0.45 percent of these economies' total imports. With the exception of the concern raised by India's use in particular (1.8 percent of its total 2007 imports), country-by-country estimates indicate that the new protectionism thus far covers only 0.2 to 0.8 percent of these economies' total pre-crisis (2007) levels of imports.

While the level of trade affected thus far may be small for most of these economies, in section 3 we make a first assessment of some of the case-level data and identify many possible ways in which the crisis use of these import-restricting trade remedies may have economically important welfare-distorting effects. These potential losses go beyond the first-order concern of the size of lost imports associated with targeted products, and the losses to domestic consumers and using industries that suffer due to reduced access to imported varieties and higher prices. An established body of economic research identifies a number of unintended and adverse consequences associated with a nation's resort to these trade remedies. We use this literature to guide our more detailed investigation of individual cases. We provide examples from crisis period cases in which firms may be using such remedies to generate anti-competitive effects, thus imposing an additional burden on consumers. This may especially be the case in concentrated sectors such as chemicals and in steel, in which recent M&A activity and a legacy of foreign direct investment create an environment in which multinational firms and their subsidiaries have access to trade remedies *in multiple jurisdictions* and the possibility of abusing them to segment markets.

The data on the crisis use of trade remedies also suggest that current protectionism, while limited, could quickly lead to escalating protectionism through at least three possible channels. The first of these is simple tit-for-tat retaliation. The second occurs after one country imposes a trade remedy on a product, and a second, third, fourth country (and so on) follows up by using their own import restrictions to target the same products, due to the fear of a 'trade deflection' surge of exports of the product into their own market. Finally, a newly imposed upstream trade barrier on imported inputs raises the cost to downstream users, creating competitiveness concerns that can generate additional downstream industry demands for cascading protectionism. The possibility that the major G20 economies are currently invoking policies that may increase the probability of a spiralling 1930s-style resort to Great Depression protectionism is therefore still a primary concern during the global crisis.

2. MONITORING THE COMBINED USE OF TRADE REMEDIES

Economic evidence from historical data (for example Knetter and Prusa, 2003; Irwin, 2005) finds a strong link between an *increase* in the use of trade remedies

during economic downturns associated with recessions and exchange rate shocks The effort to track, assess, and examine the impact of the spread of protectionism during the current global economic crisis is complicated. First, the use of the 'traditional' trade remedy instruments of antidumping (AD) and global safeguards (SG) has spread to new countries.[1] Second, many countries are also adopting and implementing the use of other 'new' trade remedy instruments such as China-specific transitional safeguards (CSG) and countervailing duties (CVD) under 'anti-subsidy' laws[2] Of the four policy instruments that we include in our analysis, the CSG is the least well known because of its relatively recent arrival on the scene – it is an instrument to which WTO members negotiated access beginning in 2001 (as part of China's agreement to accede to the WTO) and it remains in place as a potential import-restricting policy instrument through to 2014. The other lesser-known and historically lesser-utilised instrument is the CVD policy. There may be some cause for speculation of a global shift towards increased use of this particular anti-subsidy instrument associated both with increased pressure relating to exports from China, as well as to the current spread of the use of subsidies in government stimulus packages in the light of the global economic crisis.[3]

Therefore, while we are interested in tracking the combined use of these relatively substitutable forms of import protection, especially in light of the global economic crisis, doing so requires more than simply additively aggregating their use. Some of these trade remedy instruments apply to specific foreign countries, while others are applied on a more non-discriminatory, most-favoured-nation (MFN) basis across foreign sources.[4] In the presence of multiple trade remedy instruments which can be 'substitutes' providing the same access to import protection, one way to normalise the data to assess the frequency of their *combined* use over time is to examine *non-redundant* requests for new protection under-

[1] For surveys see Blonigen and Prusa (2003) for antidumping, and Bown and Crowley (2005) for safeguards.

[2] India's activity in Q1 2009 provides an illustrative example: India initiated three AD investigations, three CSG investigations, two SG investigations, and its first ever CVD investigation, also one in which it targeted China.

[3] The first reason is the increasingly prominent role of China's exports in the world trading system and the fact that, unrelated to the financial crisis, the United States changed a 23-year-old policy in March 2007, when the Department of Commerce indicated it would now 'consider' industry petitions for import protection under the nation's countervailing duty initiations against China. As one of the pivotal players in the rules-based WTO system, the signal that the United States sent by initiating CVD use against China may spur other WTO member countries to adopt a similar approach. The second reason is due to the massive subsidies that major economies are currently imposing as part of their stimulus packages to deal with the global economic crisis. Some trading partners may seek to use CVDs to address what they perceive as the trade-distorting effects of such subsidies.

[4] In principle these trade remedy instruments do require different forms of evidence before they can be applied. AD requires evidence of less-than-fair-value pricing (dumping) and injury to the domestic industry from the dumped imports; CVD requires evidence of foreign subsidisation and injury; SG requires evidence of injury caused by increasing imports; and CSG requires evidence of injury caused by increasing imports from China. Nevertheless, economic research such as Bown (2004) and Bown and McCulloch (2003) has shown that these instruments can be applied in ways that have similar effects on trade flows.

taken within a policy-implementing economy at the *product* level.[5] For example, such an approach does make a country's use of AD or CVD targeting multiple foreign sources of the same imported product more comparable to global safeguard (SG) protection. This is the approach we adopt in sections 2.1 to 2.5, before examining, in section 2.6, the collective size of the imports likely to be affected by the use of these trade remedy instruments.

In the next sub-section we begin our discussion of the combined use of these trade remedies. For readers interested in tracking the trends in the underlying data on a policy-by-policy basis, appendix figures A7.1 to A7.4 present information on the initiations and measures imposed of each of the four distinctive trade remedy instruments over time.

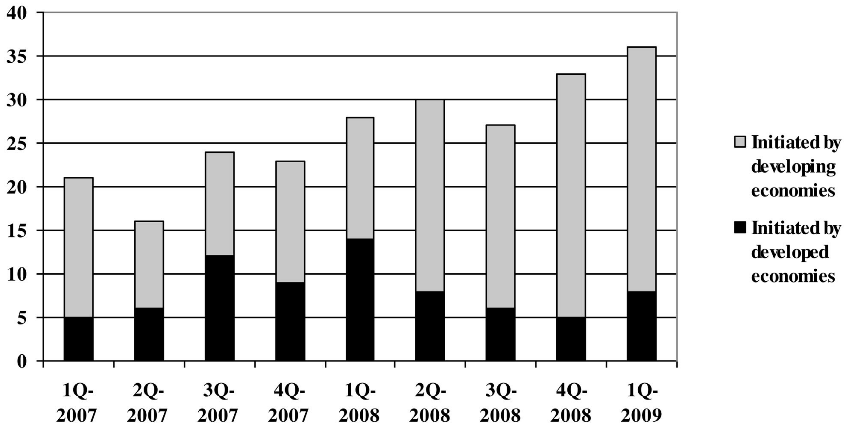
2.1 The increase in the use of the trade remedy during the crisis

As Figure 7.1a indicates, WTO members initiated 35 new product-level investigations requesting the imposition of new import restrictions under national trade remedy laws during the first quarter (Q1) of 2009, our most recently available data.[6] This is an increase of 22.3 percent compared to the same period in 2008 and it continues an upward trend. The total number of new, product-level, import-restricting investigations launched in 2008 was 34.0 percent higher than the number of new investigations initiated during 2007. It is worth pointing out, however, that 2007 was a relatively low point for new trade remedy initiations under instruments such as AD, SG, and CSG (see again appendix figures A7.1 to A7.4).

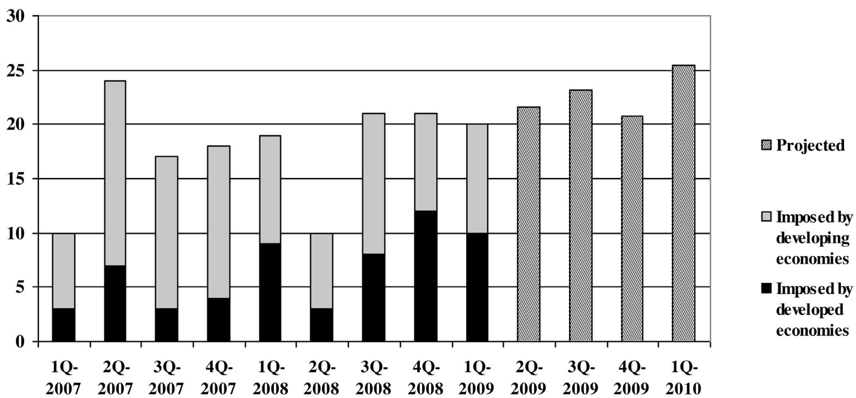
The historical data on the use of these trade policies, especially in the case of the dominant AD instrument in use in many countries around the world, indicate that the vast majority of new investigations and requests for import protection ultimately result in the imposition of new 'definitive' import restrictions in the form of tariffs, price undertakings, or quantitative restrictions. While the share of new investigations resulting in the imposition of final measures in developed economies like the United States and the EC countries may have recently fallen to the range of 50–60 percent, the share is much higher in many developing countries. This includes some of the countries that are the major new sources of the current rise in initiated investigations (for example, India and Turkey), where

[5] For example, by an initiation or measure being defined at the *product level*, we mean that the United States' two Q2 2008 antidumping investigations of 'Certain circular welded carbon quality steel line pipe' from Korea and from China are treated as one product-level investigation. Furthermore, to ensure product-level initiations are not *redundant* across policy instruments, a WTO member's simultaneous AD and CVD cases over the same product are treated as one case. For example, the US Q2 2008 simultaneous AD and CVD investigations of 'Certain circular welded carbon quality steel line pipe' from China are also treated as one product-level investigation.

[6] Most of this activity is antidumping; however the use of other instruments has been increasing recently. As described in the *Global Antidumping Database*, these figures are based on origin-source, nationally provided data for AD and CVD. The data reported in the text and figures are based on those collected for 20 AD- (18 CVD-) using countries, and while this does not comprehensively cover the global use of the instrument, historically these countries represented 90 percent of AD (93 percent of CVD) initiations by all WTO members during 1995–2007. The data collected on countries' use of SG and CSG are comprehensive and obtained from the WTO in addition to national government sources.



a. New Import-restricting Trade Remedy Investigations at the Product Level



b. Newly Imposed Import-restricting Trade Remedies at the Product Level, Including Projected Impositions through Q1 2010

Figure 7.1: *Combined Use of Import-Restricting Trade Remedies, Q1 2007–Q1 2009*

Source: Compiled by the author from the Global Antidumping Database. These are non-redundant AD, CVD, SG, CSG at the product level. The Figure 7.1b projections for 12 2009 through Q1 2010 are based on the 2007 year rate of 79 percent of initiations subsequently resulting in definitive measures, the 2007 average of a 4-quarter lag between initiation and imposition of final measure, and the rate of initiations between Q2 2008 and Q1 2009 documented in Figure 7.1a.

it is not uncommon to find 80–95 percent of the initiations resulting in the imposition of new measures. Overall, 79 percent of the investigations initiated in 2007 that reached the stage of a final determination by Q1 2009 resulted in the imposition of a definitive import restriction.

Figure 7.1b tracks the imposition of new measures at the product level across the same sample of WTO members illustrated in Figure 7.1a. WTO members imposed 20 new *product-level* definitive import restrictions in Q1 2009 under national trade remedy laws, an increase of 5.1 percent compared to Q1 2008; the annualised rate translates to the frequency of new import restrictions in 2009 to be 11.9 percent higher than the rate at which definitive new measures were imposed in 2008.

However, this annualised figure will certainly under-predict the *actual* increase in imposed measures in Q2 to Q4 of 2009. The increase in the rate of imposed measures is expected to be *larger* than 11.9 percent, higher than the number imposed in 2008, given the sharp increase in newly initiated investigations in Q2 to Q4 of 2008 (see again Figure 7.1a). To highlight this point, in Figure 7.1b we illustrate the *projected* imposition of definitive new import restrictions at the product-level for these countries between Q2 2009 and Q1 2010. These projections are computed from assumptions and parameter estimates from the 2007 data: 79 percent of new initiations result in definitive measures; it takes four quarters to reach imposition of a measure after initiation of an investigation, and the number of new investigations initiated each quarter between Q2 2008 and Q1 2009 are as in Figure 7.1a. While this approach is admittedly crude, and does not control for the likelihood that the share of investigations that may result in definitive measures may rise during the crisis, as a conservative benchmark it suggests at least an 18.5 percent increase in imposed measures in 2009 when compared to 2008.

2.2 The countries that are using the trade remedies to limit imports

In addition to documenting the time trend of trade remedy use, Figures 7.1a and 7.1b also illustrate the relative frequency with which these actions are being taken by developed versus developing economy users of import protectionist instruments. The figures indicate that increasingly these actions are being undertaken by developing countries.

Table 7.1 provides further information on the country-level use of these trade policy instruments between Q1 2007 and Q1 2009. Most striking is that since the onset of the crisis – or roughly between Q1 2008 and Q1 2009, developing countries initiated 74 percent of all new investigations. This use has been dominated by India (20 percent), Argentina (12 percent), Turkey (8 percent), Brazil (7 percent), and China (5 percent). Developed economies initiated only 26 percent of the new investigations during this time, although most of those derive from initiations by the United States (8 percent) and the European Union (7 percent).

2.3 The targeted sectors

Table 7.2 illustrates the product-level requests by sector for new import restrictions under these trade remedy instruments between Q1 2007 and Q1 2009. For

Table 7.1: *Country Use of Non-redundant AD, CVD, SG, CSG at the Product Level, Q1 2007–Q1 2009*

Countries	Initiations			Measures		
	2007 Total	2008 Total	Q1 2009 Total	2007 Total	2008 Total	Q1 2009 Total
US	14	12	1	3	13	3
EC	6	10	1	8	9	1
Canada	1	3	1	1	3	1
Australia	3	4	1	2	0	3
New Zealand	2	0	0	1	1	0
South Korea	6	3	0	0	6	2
Taiwan	0	0	0	1	0	0
Israel	0	1	3	1	0	0
Argentina	6	11	8	6	4	2
Brazil	8	10	0	11	5	1
India	14	21	9	11	11	4
Turkey	6	12	1	4	10	2
China	1	6	2	6	1	0
South Africa	5	2	1	2	2	0
Pakistan	0	3	1	2	0	0
Colombia	1	6	1	7	0	1
Mexico	3	1	1	0	0	0
Peru	2	0	1	1	0	0
Venezuela	0	0	0	0	0	0
Ukraine	5	4	2	0	5	0
Others	1	9	1	2	1	0
Developed countries total	32	33	7	17	32	10
Developing countries total	52	85	28	52	39	10
Total	84	118	35	69	71	20

Source: Compiled by the author from the *Global Antidumping Database*. These are non-redundant AD, CVD, SG and CSG at the product level.

the developed economy users, the industries most frequently resorting to these instruments are chemicals, iron and steel, and machinery, with 65 percent of the developed economy initiations since Q1 2008 occurring in just one of these three sectors. As these are the historically dominant sectoral users of trade remedies, the predominance of their use during the crisis is not surprising. Nevertheless, the recurrence of use in these sectors, and the possibility of abuse on anti-competitive grounds is a potential cause for concern and additional inquiry and is an issue to which we will return in more detail in section 3 below.

Developing country firms have also initiated a number of new requests for import protection under trade remedy instruments since Q1 2008 in the steel, chemicals, and machinery sectors (44 percent of total developing country initiations). The other two sectors with a high number of new investigations in developing countries are textiles and apparel, and plastics and rubber, which combine to ac-

Table 7.2: *Developed and Developing Economy Trade Remedy Initiations by Sector, Q1 2007–Q1 2009*

Countries	Developed Economies			Developing Economies		
	2007	2008	Q1 2009	2007	2008	Q1 2009
	Total	Total	Total	Total	Total	Total
Agriculture	2	1	0	0	1	2
Chemicals	10	8	0	17	18	8
Iron and steel	8	11	1	5	12	2
Machinery	1	5	1	8	7	3
Materials	1	0	2	4	9	1
Misc. manufactures	0	1	1	2	5	0
Other metals	0	3	0	2	5	3
Plastics and rubber	4	0	0	5	10	1
Textiles	1	1	0	6	14	6
Vehicles	0	1	0	1	2	1
Wood	5	2	2	2	2	1
Total	32	33	7	52	85	28

Source: Compiled by the author from the *Global Antidumping Database*. These are non-redundant AD, CVD, SG, and CSG at the product level. Developed countries are the United States, the countries of the European Commission, Canada, Australia, New Zealand, South Korea, Taiwan, and Israel. Developing countries are Argentina, Brazil, India, Turkey, China, South Africa, Pakistan, Colombia, Mexico, Peru, Venezuela, and the Ukraine.

count for another 27 percent of the total developing economy activity under these instruments during the crisis.

2.4 The targeted exporters

Table 7.3 illustrates the frequency with which exporters in various countries have been *targeted* by country-specific trade remedy instruments such as AD, CVD, and CSG. Given the economies that are using these trade policies, and the sectors that are being targeted for new import restrictions, it is not surprising that the exporters targeted by these actions are primarily located in other developing countries. The frequency with which developing countries as a whole have been targeted in country-specific trade remedy investigations is 72 percent during the crisis period of 2008 through Q1 2009, which is a slight increase from 68 percent in 2007.

2.5 China as the export target

The use of country-specific trade remedy instruments such as AD, CVD, and CSG documented in Table 7.3 also illustrates the intensity with which these using countries are targeting exports from China. Of the country-specific trade remedy initiations and measures imposed, China alone constituted roughly 40 percent of the total of countries named in the investigations during this period and slightly more than 40 percent of the definitive measures that have been imposed.

Table 7.3: *Exporters Targeted by Product-level Use of AD, CVD and CSG, Q1 2007–Q1 2009*

Exporting (affected) country	Initiations			Measures		
	2007 Total	2008 Total	Q1 2009 Total	2007 Total	2008 Total	Q1 2009 Total
Total	156	217	46	104	119	36
Developing country exporters	106	159	30	71	81	29
(percent of total)	(0.68)	(0.73)	(0.65)	(0.68)	(0.68)	(0.81)
Developed country exporters	50	58	16	33	38	7
China	63	86	19	46	49	16
(percent of total)	(0.40)	(0.40)	(0.41)	(0.44)	(0.41)	(0.44)
South Korea	12	9	2	5	7	2
European Union	8	15	6	4	8	1
Thailand	7	12	2	5	1	3
US	8	10	2	4	6	1
Taiwan	6	9	0	7	7	2
Malaysia	5	10	0	4	2	3
Indonesia	5	11	2	3	4	2
India	5	9	0	4	3	2
Japan	4	3	0	5	2	0
Russia	6	2	0	0	5	0
UAE	3	0	0	0	1	1
Brazil	2	3	4	2	2	0
Turkey	3	3	0	0	3	0
Others	19	35	9	15	19	3

Source: Compiled by the author from the *Global Antidumping Database.*

A different method of measuring the intensity of use of these trade remedies against China's exports is to examine this from the *product*-level perspective. For example, in Q1 2009, the other WTO members (from whom these data are derived) named China in 19 of the 27 (70 percent of) newly initiated product-level investigations under (AD, CVD, CSG) laws that require the investigating country to specifically name at least one exporting country.[7] In 12 out of these 27 (44 percent of) investigations, China was the *only* country named. Finally, in the remaining 7 instances in which China was named as one of the multiple exporting countries, there was *only one* other exporting country named in the product-level investigation. The evidence suggests that a focus of many of these trade policy initiations is to restrict imports from China.

[7] Of the 35 product-level, newly initiated investigations in Q1 2009, six did not name any exporting countries because they were global safeguards, and China initiated two investigations itself.

The WTO membership's use of trade remedy instruments to target China's exports is not new – it continues a trend dating back to China's WTO accession in 2001, and even earlier (Bown, forthcoming a). Explanations for the increasing intensity of use of these instruments against China's exports since 2001 include: China's export increase during this period: more exports means more potential foreign targets for use of antidumping and other trade remedies. China's receipt of MFN treatment in WTO members' tariff schedules since 2001 constrains WTO members' ability to impose potentially WTO-consistent (but discriminatory) import protection against China to trade remedy instruments; China continues to be treated as a 'non-market economy' (NME) in many countries' antidumping procedures, which gives AD authorities more discretion than is available vis-à-vis other exporters to calculate dumping margins. Many WTO members do not feel as though China's state-owned enterprises (SOEs) and its government's use of other explicit and implicit subsidies have been sufficiently curtailed since its 2001 accession.

One important question is whether the global crisis *increases* the intensity of use of these instruments against China's exporters relative to exporters in other WTO member countries. Will the phenomenon of using trade remedies to target China create additional political pressure within China either to increase its own use of trade remedies (perhaps as a response partially-motivated by retaliation), or to take a more active role in the WTO to attempt to slow down the use of these instruments (perhaps through formal dispute settlement, where it has been thus far slow to engage)?[8]

Finally, Figure 7.2 illustrates the relative frequency with which trade-remedy-using countries are targeting China's various export sectors with newly initiated investigations. There are a number of Chinese exporting industries facing newly initiated investigations during this period – including chemicals, iron and steel, machinery, and textiles. We return to a more detailed discussion of the same Chinese export products being targeted in different foreign markets in our more detailed discussion of some of the underlying cases in section 3 below.

2.6 The size of the imports under attack from the use of such trade remedies

Here we provide a first attempt to assess the size of the potential economic problem these potential trade remedies pose. That is, how much trade is coming under attack from the increasing resort to trade remedies?

Table 7.4 provides a first pass at this question by documenting a number of pieces of data on the size and relative importance of the 2007 (that is, pre-crisis) level of trade at the level of 6-digit Harmonised System (HS) imports associated with the products, and exporting countries, that are the targets of most of the G20's newly initiated investigations since the beginning of 2008 and continuing through Q1 2009.[9] The table reports four columns of data: the 2007 value of im-

[8] For a discussion of recent dispute activity at the WTO between the United States and China, see Bown (2009b).

[9] The 2007 imports are the last year for which the data are systematically available across all of these countries.

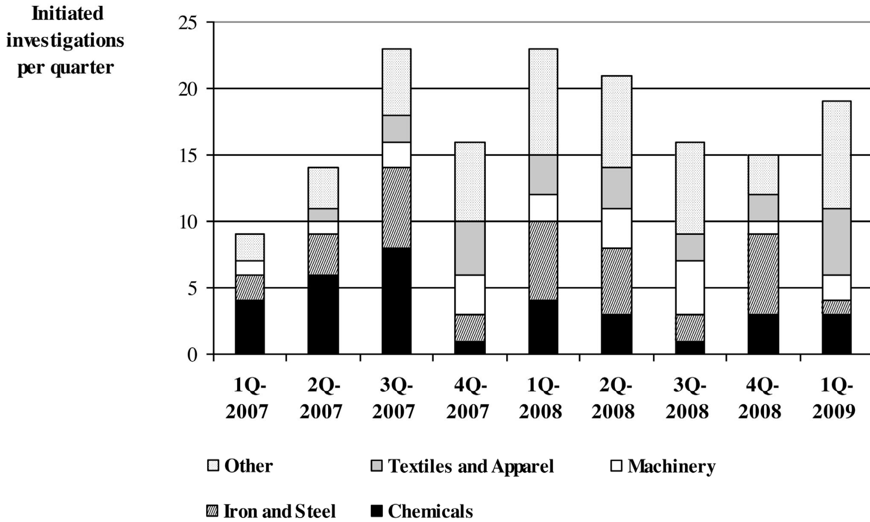


Figure 7.2: *Newly Initiated Import-restricting Trade Remedy Investigations Targeting China's Exports, Q1 2007–Q1 2009 by Sector*

Source: Compiled by the author from the Global Antidumping Database. These are non-redundant AD, CVD, CSG at the product level.

ports subsequently being targeted (that is, 'targeted imports') by each economy's new and subsequent investigations since Q1 2008; the targeted imports as a share of the country's total 2007 imports; the targeted imports deriving from China as a share of the total targeted imports, and the targeted imports deriving from China as a share of the country's total imports from China. We construct this table for 12 of the largest WTO economies and users of these trade-remedy instruments – four developed and eight developing countries.

Not surprisingly, Table 7.4 first reveals that the two economies with the largest *levels* of imports potentially affected by the remedies are the EC countries ($8.0 billion) and the United States ($7.5 billion). However, the *relative* importance of the targeted imports is fairly small, as only 0.4 percent of 2007 imports in these economies are in 6-digit HS product categories that have become subject to new investigations initiated since Q1 2008. Table 7.4 also indicates that developed countries such as Canada and Australia not only have a much smaller level of trade potentially affected, but the targeted imports measured as a share of their total imports is much smaller than the United States and the European Community as well.

The data for some of the developing economy users of these trade remedies are bit more worrisome. India, the most frequent user of these trade remedies (Table 7.1), is estimated to is have $3.9 billion in 2007 imports that have been subject to new trade remedy investigations during the crisis thus far – 1.8 percent of its total 2007 im-

Table 7.4: *The Size of Imports under Attack by the Use of Trade Remedy Initiations, Q1 2008–Q1 2009*

Importing Country	Value of 2007 imports for products facing new investigation during 2008-Q1 2009	Investigated products as a share of country's 2007 total imports	Investigated imports from China as a share of all investigated imports	Investigated imports from China as a share of all imports from China
Total	$28,977,070,131	0.0045	0.5889	0.0164
Developed Economies				
EC	$8,032,246,785	0.0041	0.3983	0.0101
US	$7,458,154,471	0.0037	0.9032	0.0198
Canada	$852,235,098	0.0022	0.9160	0.0218
Australia	$95,253,092	0.0006	0.7643	0.0030
Developing Economies				
China	$6,183,277,841	0.0064	na	na
India	$3,943,953,974	0.0180	0.4749	0.0762
Turkey	$1,383,230,509	0.0081	0.1452	0.0152
Brazil	$540,548,035	0.0044	0.5787	0.0248
Argentina	$315,794,401	0.0070	0.5221	0.0324
Pakistan	$108,991,018	0.0033	0.5405	0.0141
Mexico	$55,581,511	0.0002	0.3106	0.0006
South Africa	$7,803,396	0.0001	0.7216	0.0007

Sources: Product level (6-digit HS codes) for AD, CVD, CSG, and SG investigations for these countries obtained from the Global Antidumping Database and matched to the 6-digit HS Comtrade 2007 import data available via WITS. Intra-EC trade is excluded.

ports. China (0.64 percent), Argentina (0.7 percent) and Turkey (0.8 percent) are other examples of countries whose share of their total 2007 imports being subject to new import restrictions during the crisis is greater share than that of the United States and European Community. China is an interesting case, because while its underlying frequency of cases has been limited during the crisis (only 8 new product-level initiations since Q1 2008), the investigations collectively covered a relatively sizable level of 2007 imports ($6.2 billion).

Before moving to relative comparisons of the data, it is worth noting that there are at least three reasons to speculate that the Table 7.4 estimates on the value of imports affected by crisis use of trade remedies thus far are likely to provide an *upper bound* on the total size of imports affected by these trade remedy initiations. The reasons are first that the trade data are matched to the trade remedy data at the 6-digit HS level; in practice many countries impose trade remedies at the 8- or 10- digit HS level, thus not affecting all sub-products within a given 6-digit category. Second, not all of these newly initiated investigations will result in imposed measures;[10] and finally, imports in 2008 and 2009 may fall from

[10] Nevertheless, research such as Staiger and Wolak (1994) has shown that the mere harassment of initiations can have an adverse effect on trade flows, even in cases in which definitive trade restrictions are not imposed.

their pre-crisis (2007) levels for reasons unrelated to trade remedies, but instead because of other (demand side income effects or supply side credit constraints) shocks associated with the crisis.[11]

Next, Table 7.4 also reveals how the potential economic impact of the trade remedy use during the crisis period may affect China's exports differentially depending on the using country. Of the combined imports targeted by these 11 other economies use of trade remedies since the crisis, 58.9 percent of those targeted imports derived from China's exporters alone. On a country-by-country basis, this ranged from more than 90 percent of the imports subject to investigations in the United States and Canada, to only 31 percent in Mexico and less than 15 percent of the imports targeted by Turkey's use of new trade remedies.

According to the top row of data in Table 7.4, 1.6 percent of China's total 2007 exports to these 11 other economies were in 6-digit HS products that would become subject to their newly initiated trade remedy investigations sometime after the beginning of 2008. Not surprisingly, there is substantial variation in this statistic across the 11 economies. The highest is India, which has subsequently initiated investigations under one of its trade-remedy laws (during 2008 through Q1 2009) covering more than 7.6 percent of its 2007 imports from China. Other countries that have investigated a relatively large share of their total 2007 imports from China during this same subsequent economic crisis period include Argentina (3.2 percent), Brazil (2.5 percent), Canada (2.2 percent), and the United States (2.0 percent).

Finally, while these are not broken down in Table 7.4 specifically, it is worth noting that some of major economies do have two or three large trade value cases that may be the ones that largely determine just how much trade will be affected by the use of trade remedies during the crisis. Particular examples for the United States include the China safeguard (CSG) case initiated in April 2009 over 'Tyres', which has the potential to impact on $1.9 billion of imports from China (2007 values). The European Community has more than half of its $8 billion in imports under investigation being tied up in only three different product-level investigations. The European Community has $2.7 billion in imports from the United States associated with two cases initiated in 2008 – the 'Biodiesel' case for $1.7 billion and 'Prepared binders for foundry moulds or cores' for $970 million. (Coincidentally, with respect to this last case, the United States has a simultaneous investigation over the same 6-digit HS product imported from China.) The third major EC case is its investigation involving 'Flat-rolled products of stainless steel' from China, Korea and Taiwan, as it had 6-digit HS imports totalling $1.8 billion in 2007. Finally for China's use of trade remedies, more than half ($3.7 billion) of the $6.2 billion in potentially affected imports stems from a 2009 case covering 6-digit HS imports from Korea and Thailand of 'Terephthalic acid.'[12]

[11] Furthermore, the likelihood of trade diversion (Prusa 1997, 2001; Konings et al. 2001; Bown 2004) with the discriminatory application of these trade remedies indicates that even some of the imports destroyed by the imposition of new trade barriers (from the named sources, what we have used to construct Table 7.4) will result in increased imports of the same product from non-named foreign sources.

[12] Again, the estimate of the size of trade at stake in these cases may be over-estimated, given that our data derive from the 6-digit HS import data and not the sub-products at the 8- or 10-digit HS level that may be applied in these particular investigations.

3. QUESTIONS RAISED BY THE EARLY DATA ON USE DURING THE CRISIS

Even if the overall level of imports affected by the increasing use of these trade remedies during the crisis is not currently large, economists have a long-established line of research identifying many channels through which the use of these policy instruments can generate unintended consequences with costly implications for economic welfare. In this section we use this economic research to guide our investigation of underlying cases that constitute potentially worrisome examples of resort to trade remedies during the crisis.

3.1 Crisis protectionism leading to escalating protectionism?: Tit-for-tat retaliation, trade deflection, and cascading protectionism

In this section we explore three channels through which the current resort to trade-remedy protectionism during the global crisis creates incentives for follow-on use by others of trade remedies, and the possibly worrisome escalation of protectionism. To begin this exercise, we examine the use of trade remedies across countries over 'common products' listed in Table 7.5. The table presents 35 instances in which *more than one* policy-imposing country initiated a trade remedy investigation over the same 6-digit HS product(s) during the period covered by Q1 2007 through to Q1 2009. These 35 product examples cover more than 70 unique 6-digit HS codes. The table presents the name of the product, the 6-digit HS product(s) common to the investigating countries, the names of the countries undertaking the common investigations, as well as the name of the targeted exporters associated with each investigation. The product list is organised numerically by the underlying HS codes.

The first channel is that firms may use a policy like antidumping to discipline foreign rivals in direct tit-for-tat retaliatory actions. While it is relatively rare for two economies to target one another with simultaneous investigations over essentially the varieties of the same product, one possible example of direct AD retaliation within varieties of the same product involves the recent US-EC interaction over sodium products (case 1 on Table 7.5). In October 2007, the US firm EI DuPont de Nemours & Co. was a domestic petitioner requesting initiation of a US AD investigation over 'Sodium metal' from France, accusing the French firm Métaux Spéciaux (MSSA SAS) of dumping into the US market. In May 2008, the United States imposed a preliminary AD duty of 62.62 percent. In July 2008, the Eropean Community initiated AD and CVD investigations over 'Sodium metal' from the United States in the same 6-digit HS product category. In December 2008, in the US investigation, the USITC ruled negative on injury determination, and thus no final measures were imposed. At the spring of 2009, the EC investigation was still ongoing.

Of course it is also not necessary for retaliation (that is, the current trade remedy provoking use of future protectionism) to be limited to only instances in which countries import and export the same product. One country's excessive

Table 7.5: *Examples of Product Overlap of Trade Remedy Investigations across Countries, Q1 2007–Q1 2009*

	Product	Common HS Code (6-digit)	First Initiating Country	Subsequent Initiating Countries	Targeted exporters (initiated case in which named)
1	Sodium	280511	1. US	2. EC	EC (1); US (2)
2	Nitrites	283410	1. US	2. India (CVD)	China (1,2); EC (1)
3	Citric acid	291814	1. South Africa	2. EC	China (1,2,3); Canada (3)
				3. US	
	Citric acid	291815	1. EC	2. US	China (1,2); Canada (2)
4	Matches	360500	1. US	2. Ukraine (SG)	India (1)
5	Prepared binders for foundry moulds or cores	382490	1. US	2. EC	China (1); US (2)
6	Polyethylene terephthalate (PET) film	392062	1. Brazil	2. US	India (1,3); Thailand (1,2); Brazil (2); China (2); UAE (2)
				3. Turkey (CVD)	
7	Polyesters	392069	1. Brazil	2. Turkey (CVD)	India (1,2); Thailand (1)
8	Motor car tires	401110	1. Brazil	2. US (CSG)	China (1,2)
9	Bus and truck tires	401120	1. US	2. Brazil	China (1,2,3); Thailand (3)
				3. India	
10	Laminated flooring	441113, 441114,	1. Turkey	2. India	China (1,2,3); EC (3); Malaysia (2); New Zealand (2); Sri Lanka (2);
		441192, 441193		3. Argentina	Switzerland (3); Thailand (2)
11	Bound stationery	482010	1. New Zealand	2. US	China (2); EC (2); Korea (2); Malaysia (1)
12	Cotton yarn	5205, 5206	1. Turkey (SG)	2. Peru (SG)	All because SG
13	Polyester yarn	540233	1. Turkey	2. Argentina	China (1,2); Indonesia (1,2); India (2); Malaysia (1); Taiwan (2); Thailand (1)
14	Polyester fibre	550320	1. Pakistan	2. Argentina	China (1,2,3); India (2); Indonesia (2); Taiwan (2)
				3. South Africa	
15	Artificial staple fibres of rayon	550410	1. Brazil	2. India	China (1,2); Indonesia (1,2); EC (1); Taiwan (1); Thailand (1)
16	Certain yarn	550931, 550932	1. Turkey	2. Argentina	Indonesia (1,2); Brazil (2); China (1); India (1)
	Certain yarn	551011	1. Turkey	2. Brazil	China (1,2); Indonesia (1,2); India (1,2); EC (2); Taiwan (2); Thailand (2)
17	Blankets and travelling rugs	630140	1. Brazil	2. Egypt (SG)	China (1)
18	Footwear	640219, 640291, 640319, 640340,	1. Brazil	2. Canada	
		640391, 640411, 640419		3. Argentina	China (1,2,3); Vietnam (2)
	Footwear	640212, 640220, 640299, 640312,	1. Brazil	2. Argentina	China (1,2)
		640320, 640351, 640359, 640399,			
		640510, 640520, 640590			
	Footwear	640110, 640192, 640199	1. Canada	2. Argentina	China (1,2); Vietnam (1)
19	Ceramic tiles (unglazed)	690790	1. Ecuador (CSG)	2. Jordan (SG)	China (1)
	Ceramic tiles (glazed)	690890	1. Ecuador (CSG)	2. India	
				3. Morocco (SG)	China (1,2)
				4. Jordan (SG)	
20	Tableware and kitchenware	691110, 691200	1. Ecuador (CSG)	2. Argentina	China (1,2)
21	Wire of iron or non-alloy steel	721710	1. EC	2. Indonesia (SG)	China (1)

Table 7.5: *Examples of Product Overlap of Trade Remedy Investigations across Countries, Q1 2007–Q1 2009 continued*

	Product	Common HS Code (6-digit)	First Initiating Country	Subsequent Initiating Countries	Targeted exporters (initiated case in which named)
22	Flat-rolled products of stainless steel	721931, 721932, 721933, 721934, 721935	1. EC	2. India	China (1,2); Korea (1,2); Taiwan (1,2); Japan (2); EC (2); South Africa (2); Thailand (2); US (2)
23	Pipes and tubes	730429	1. Canada	2. Ukraine (SG) 3. EC	China (1,3)
	Pipes and tubes	730630	1. US	2. EC 3. Canada 4. Australia	China (1,2,3,4); Belarus (2); Bosnia Herzegovina (2); Malaysia (4); Russia (2)
	Pipes and tubes	730661	1. US	2. EC 3. Australia	China (1,3); Turkey (1,2); Belarus (2); Korea (1); Malaysia (3); Mexico (1); Ukraine (2)
24	Iron or steel chain	731582	1. South Africa	2. Argentina	China (1,2)
25	Iron or steel nails, tacks, pins, corrugated nails, staples	731700	1. US	2. Indonesia (SG)	China (1); UAE (1)
26	Screws and bolts	731815	1. EC	2. US	China (1,2)
27	Aluminium bars, rods and profiles	760421, 760429, 760820	1. South Africa	2. Canada	China (1,2)
28	Aluminium foil	760711	1. EC	2. India (CSG)	China (1,2); Armenia (1); Brazil (1)
29	Heat pumps	841861	1. Argentina	2. Canada	China (2); Malaysia (1); Thailand (1)
30	Refrigerators	841899	1. Canada	2. US	China (1,2)
31	Food grinders, processors and mixers	850940	1. Turkey (SG)	2. Argentina	China (2); Brazil (2)
32	Recordable DVDs and CDs	852340	1. India	2. Brazil (SG) 3. Argentina	China (1); Hong Kong (1); Paraguay (3); Taiwan (1)
33	Articles of graphite	854511	1. US	2. Brazil	China (1,2)
34	Road wheels and parts and accessories thereof	870870	1. Australia	2. Argentina	China (1,2)
35	Parts and accessories of motor vehicles	870899	1. Argentina	2. India	China (1,2)

Source: Compiled by the author from the Global Antidumping Database.
The table identifies more than 70 distinct 6-digit HS codes with at least two different countries newly initiating trade remedy investigations over the same code between Q1 2007 and Q1 2009.

reliance on the use of trade remedies can lead to its exporters becoming foreign targets in other products in the same industry, or in other industries altogether, thus expanding the potential escalation of protectionism.[13] This is of particular concern given the current economic crisis and the desire to avoid repeating the spiral of protectionism associated with the 1930s and the Great Depression era.

A second concern raised by the 'Sodium metal' cases is that even if no antidumping measures are imposed, the two firms that would otherwise compete vigorously with each other in the US and EC markets (resulting in lower prices for consumers) may be able to use the AD process to reach an implicitly collusive agreement to less vigorously compete in each other's market (thus hurting consumers). We further explore possible anti-competitiveness effects to the use and abuse of trade remedies in section 3.2 below.

A second channel through which current protectionism may create incentives for future, additional protectionism is associated with the phenomenon of 'trade deflection' (Bown and Crowley 2006, 2007; Durling and Prusa, 2006) in which follow-on countries may resort to use of these trade policy instruments to prevent export surges of the same product to the first country's trade remedy imposition. As one potential example, consider the 'Footwear' cases associated with product number 18 in Table 7.5. Brazil began the potential cascade of protectionism in footwear by initiating an antidumping investigation against China in December 2008. Fearing that the trade shut out of the Brazilian market may then 'deflect' from that market and surge into its own market, other importing countries may be prompted to implement their own trade remedies on imports of the product, perhaps against the same exporter. In the case of footwear, Argentina followed Brazil's AD case against China by initiating an AD case of its own against China in March 2009 (Canada had also initiated a footwear AD against China in February 2009). The existence of so many examples of product overlap in Table 7.5, as well as the frequency with which common exporters are being targeted across countries, suggests this may be a part of the explanation for these and future acts of protectionism in the data.[14]

A third channel of current use of trade remedies creating additional incentives for future use is sometimes referred to as 'cascading protectionism' (Hoekman and Leidy, 1992). Another concern raised by the Table 7.5 list of products is the number of measures likely to affect intermediate inputs. Imposing new trade barriers on inputs can adversely affect downstream producers by increasing their costs, thus decreasing their competitiveness in the global marketplace with other foreign suppliers that do not face such additional costs.[15] One important example from Table 7.5 is found in products 12 through 16, which are various forms

[13] Studies of the retaliatory links and incentives created under antidumping include Blonigen and Bown (2003), Prusa and Skeath (2004), and Feinberg and Reynolds (2006).

[14] There are other possible explanations for this aside from trade deflection which merit investigation as well. One example is Brazil identifying Chinese footwear producers of dumping informed domestic firms in Argentina (and Canada) which triggered their initiatives to pursue cases as well.

[15] For a theory and an empirical application to the steel industry of how trade remedies can be used strategically to raise a rival firm's costs, see Durling and Prusa (2003).

of yarns and fibres that are crucial inputs into the production of textiles and apparel, an important source of industrial output and exports for many developing countries. Interestingly, the countries that are *imposing* these new restrictions on yarn and fibres are Turkey, Peru, Argentina, South Africa, Brazil, and India. These developing economies are many of the same countries whose textile and apparel industries are already struggling to compete with China's textile and apparel exports in global markets. Using trade remedies to raise the cost of an integral input is likely to have unintended and yet important downstream competitiveness consequences, including increasing the probability that these developing economies' textile and apparel producers may themselves be the next in line demanding their own protectionism through trade remedies.

3.2 Antidumping, multinational firms, and potential concerns of anti-competitive behaviour

There are a number of additional worries when it comes to the use of policies such as antidumping. Firms may abuse the policy by convincing government policymakers to impose trade barriers that, while in the firms' interest, are not in the overall interest of the country. There are a number of mechanisms through which firms may manipulate such policies – including by using them as a tool to get government policymakers to assist (perhaps unwittingly) firms to segment markets (raising anti-competitiveness concerns), and as a tool to raise domestic rivals' costs. The potential for abuse is increasingly heightened when the key industrial users of the policies are multinational firms with headquarters and subsidiaries situated globally that have the ability to tap into (and to be affected by) trade remedies in many different political jurisdictions.[16]

First, the desire to segment markets identified in the US-EC 'Sodium metal' cases described in section 3.1 is not limited to rival firms, but it may also take place between subsidiaries of the same firm. A careful examination of the repetitiveness of firm names in trade remedy initiations (compiled into the publicly available *Global Antidumping Database*) allows us to identify two potential examples worthy of further investigation.

One example is an instance in November 2008 in which the United States imposed definitive AD duties on 'Polyethylene Terephthalate (PET) film, sheet, and strip' from China, including 3.49 percent on DuPont Teijin Films China Ltd. According to its website, DuPont Teijin Films is a 50–50 global joint venture between the American firm DuPont and the Japanese firm Teijin.[17] According to the public records in the case, the American subsidiary DuPont Teijin Films is one of the domestic petitioners behind the US effort to target the Chinese subsidiary of the same firm with new import restrictions that could have the effect of segmenting markets.

[16] Important contributions to the economic research literature on the ways in which access to antidumping can inadvertently increase the concern for anti-competitive behaviour include Prusa (1992), Messerlin (1992), and Veugelers and Vandenbussche (1999).

[17] See http://www.duponteijinfilms.com.

A second example took place when India imposed a definitive AD measure on 'Compact fluorescent lamps' from China in February 2009. The measure was an agreement that Chinese firms, would voluntarily agree to raise prices and for a given downward-sloping import demand curve, by extension, reduce export volumes. One of the Chinese firms agreeing to the new price undertaking was Osram China Lighting Co. Ltd., a subsidiary of Osram, which is a German-headquartered firm. This is particularly interesting given that one of the domestic petitioning firms was Osram India Pvt. Ltd., the Indian subsidiary of the same German-headquartered parent Osram.[18] Thus this is an example of one subsidiary targeting another subsidiary with a new trade restriction that could also have the anti-competitive effect of segmenting markets.

As a second channel through which multinational firms and foreign direct investment may have distorting effects on the use of trade remedies, consider a situation in which the imposition of import protection in the past created incentives for firms to expand the reach of their multinational operations and 'tariff jump' to avoid trade barriers by creating local producers that would not be subject to future import restrictions.[19] Once a multinational firm has the local presence, it may become part of the domestic industry petitioning to use trade-remedy instruments to increase the likelihood of import restrictions against other foreign sources (that have not established a local presence), thus affecting the discriminatory application of the trade-remedy use. Blonigen and Ohno (1998), for example, provide a model in which foreign firms that locate production in the home country then use increased exports to increase protectionist pressures within the home country to trigger new and larger barriers against other foreign competitors in future periods.

The recent wave of mergers and acquisitions (M&A) in the global steel industry in particular created a number of potential instances in which this sort of behaviour by firms is now possible. Consider the activities of Indian steel firms such as Mittal, which acquired the European steel producer Arcelor (to become ArcelorMittal) in 2006, and Tata, which merged with the UK steel firm Corus in 2007, and how this may affect the current application of trade-remedy use in both the European Community and in India during the global economic crisis.

In the case of the European Community, consider three examples of recent AD petitions for new trade remedies over steel products that have involved ArcelorMittal and (or) Corus-Tata being part of the domestic EC industry petitioners bringing forward a case. In December 2008, the European Community imposed definitive AD duties on 'Certain welded tubes and pipes of iron or non-alloy steel' from Belarus, China, and Russia. In February 2009, the European Community imposed preliminary AD duties on 'Wire rod' from China, Moldova, and Turkey. In April 2009, the European Community imposed preliminary AD duties on 'Certain seamless pipes and tubes' from China. In *none* of these cases did the trade reme-

[18] See http://www.osram.com/osram_com/About_Us/The_Company/index.html.

[19] Even antidumping itself may create incentives for firms to engage in FDI to avoid future application of such trade restrictions. For evidence, see Belderbos (1997) and Blonigen (2001).

dies target imports from India, despite Indian exporters being a major competitive producer of steel globally.

With respect to India's own use of new import restrictions over steel during the crisis, the global M&A activity by Indian steel firms also has the potential to shape which foreign targets are affected by its potentially discriminatory application of antidumping. As a potential example, in March 2009 India imposed preliminary AD duties on 'Cold-rolled flat products of stainless steel' from the European Community and seven other exporting countries. The Indian domestic petitioner behind this particular case was Jindal Stainless Limited, and not domestic firms like Tata or Ispat from the Mittal Group.[20] On the other hand, when the Indian domestic petitioners including Ispat (Mittal Group) filed a December 2008 AD investigation over 'Hot rolled steel products' from 15 exporting countries, the only EC member state named in the investigation was the most recently added member, Romania.

While these examples are surely not conclusive evidence of anti-competitive behaviour, given the scope for abuse of antidumping and other trade remedy provisions, these and other AD investigations should be closely monitored. One serious concern is that firms will use the cover of the global economic crisis to stoke protectionist sentiment and these trade remedies will inadvertently be applied by government policymakers in a way that *reduces* competitiveness conditions. This has the potential for far-reaching and longer-lasting effects than the costs imposed on consumers and consuming industries associated with the 'mere' imposition of trade restrictions.

4. POLICY IMPLICATIONS AND CONCLUSIONS

The global economic crisis has been accompanied by an increase in the global use of import-restricting trade remedies as a protectionist response. While the data suggest that there has been an increase, the scale of the use of these particular policy instruments has been limited. The most intensive use has been in developing countries, and the biggest and most worrisome user is India. The export targets of the new protectionism are increasingly concentrated in other developing countries, and the intensity of use against China's exporters is also of concern for the longevity and sustainability of the trading system.

While the scale of the problem associated with the use of trade remedies during the crisis thus far is not massive, there are a number of worrisome trends in how it is being use to suggest that future use may also increase, due to retaliation, the response to trade deflection concerns, and cascading protectionism to downstream industries. The use of antidumping during the crisis in sectors with substantial recent M&A activity also stokes concerns of potential abuse and anti-

[20] However, Jindal Stainless Limited does report on its website the subsidiaries in the United Kingdom (Jindal Stainless UK Limited, London) and Italy (Jindal Stainless Italy S.r.l.), see http://www.jindalstainless.com/subsidiary-companies.html , last accessed on 10 June, 2009.

competiveness concerns that firms may be using these policies in their attempts to segment markets.

The first lesson for policymakers stemming from these data and from decades of economic research into the effects of these policies is to hold the line. To the greatest extent possible, policymakers should refuse new requests to implement such acts of import protection through trade remedies.

However, if it is not possible to dismiss all the requests for protection, economists have a duty to advise policymakers on how to impose any new trade barriers in a means that is least distortive and costly (in terms of economic efficiency) and lasting for as short a period as possible. If policymakers must resort to use trade remedies amidst political pressure during the economic crisis, there a number of reasons to encourage strongly that protectionism be fitted into using the global safeguards (SG) instrument and *not* the other country-specific instruments like AD, CVD, or the CSG.

First, the WTO rules require that SG protection must be applied on a non-discriminatory (MFN) basis, which is more likely to prevent potentially costly trade diversion than are trade remedies imposed in the form of AD, CVD or CSG. The imposition of an import restriction on, say, China alone may impose other efficiency costs if it just creates incentives for domestic consumers to switch their sourcing to other, higher-cost foreign suppliers that are not subject to the trade restriction. While a SG does still raise the price facing consumers, and thus imposes a cost on the economy, an efficiency 'benefit' to the policy is that it does not sever the link between any remaining imports and the identity of the most efficient *foreign* source of those imports.

Second, the WTO's SG provisions have a built-in time process for scaling back and ultimately eliminating the protection over time. This is important during the global crisis, as the speed with which countries are able to extricate themselves from their economic downturns is likely to be affected by their impediments to growth, which would include the imposition of new trade barriers taken on during the crisis. Historically, SG-imposing countries have been much more likely to remove the protectionism than has been the case for AD or CVD. And as Table 7.6 indicates, it is unlikely that adversely affected exporters will be able to resort to the WTO's dispute settlement provisions anytime soon to deal with the problem of getting potentially WTO-inconsistent AD or CVD measures removed. The table shows that the developing country exporters that are the main target of the current use of these trade remedies during the crisis have challenged less than 5 percent (38 out of 909) of the imposed measures through formal WTO dispute settlement. Thus it is better that such policies not be imposed in the first place, but that a global safeguard with a built-in phase-out mechanism, be used instead.

The third and fourth reasons to prefer SG are more subtle but nevertheless still important. Because global safeguards are 'fair trade' provisions, they are less adversarial to foreigners. Unlike AD or CVD, using SG does not require an allegation of foreign wrongdoing (dumping or illegal subsidies). Instead, SG entails greater recognition and acceptance that the act of protectionism is a response to

Table 7.6: *WTO Member Antidumping and Countervailing Measures Initiations, Impositions and DSU Challenges, by Targeted WTO Exporter for 1995–2008*

Targeted WTO member	New AD Initiations	New AD Measures	Exporter uses DSU to challenge New AD	New CVM Initiations	New CV Measures	Exporter uses DSU to challenge New CVM
Total developed economy exporters	1175	722	72	72	39	15
EC	283	161	55	33	22	9
Japan	144	106	2	0	0	0
US	189	115	5	7	1	0
Korea	252	150	3	16	9	3
Taiwan*	92	64	2	1	0	0
Other developed	215	126	5	15	7	3
Total developing economy exporters	1416	909	38	125	82	9
Argentina	30	15	3	6	4	0
Brazil	97	74	5	7	8	1
China*	410	295	5	23	14	5
Costa Rica	2	0	1	0	0	0
Guatemala	3	1	1	0	0	0
India	137	84	10	46	27	2
Indonesia	145	82	2	11	8	0
Malaysia	90	50	0	3	3	0
Mexico	40	27	5	0	0	0
Pakistan	10	6	0	1	1	0
Philippines	11	6	0	1	2	0
South Africa	58	38	0	6	4	0
Thailand	142	84	2	9	3	0
Turkey	44	25	2	2	1	0
Other developing	197	122	2	10	7	1
Total WTO member exporters	2591	1631	110	197	121	24

Source: Table 4–3 of Bown (forthcoming, b). *Since WTO accession in 2001.

a crisis. Using SG over AD and (or) CVD may thus decrease the likelihood of foreign retaliation and the ramping-up of protectionist sentiment in trading partners. As a final technical matter, SG is simply less costly for a bureaucracy to administer than policies such as AD and CVD, which are much more data intensive. Taking as given that the end of an investigation is simply going to result in protectionism, it seems wasteful for developing countries, in particular, to use scarce governmental resources on administering the more complex form of what are similarly protectionist policies.

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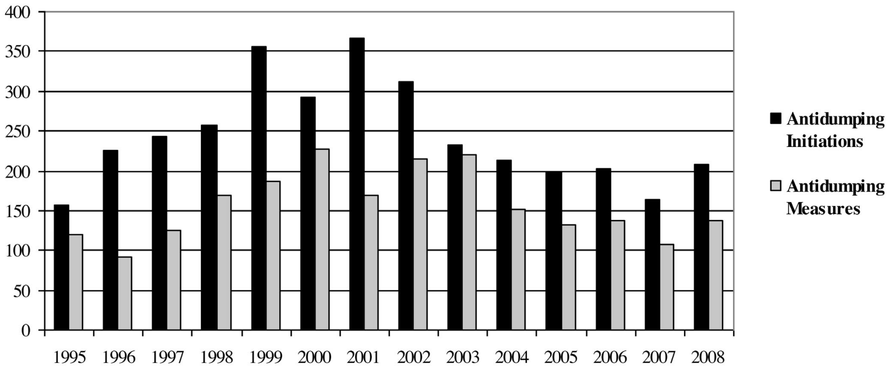
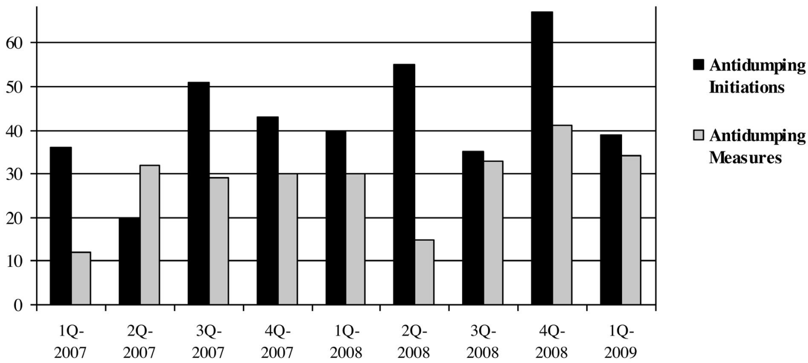
APPENDIX



AD Historically, by Year: 1995–2008

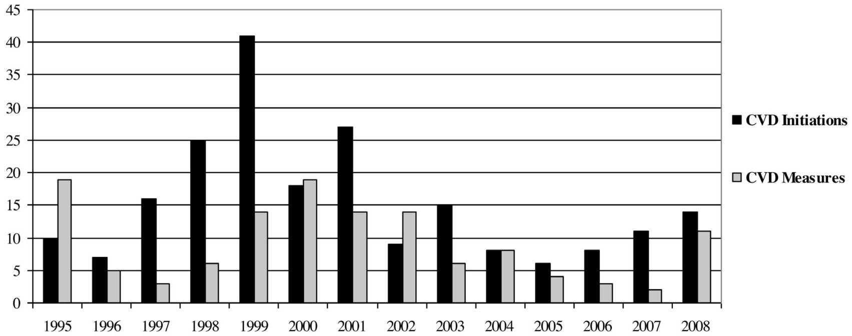


AD During the Crisis, by quarter: 1Q 2007–1Q 2009

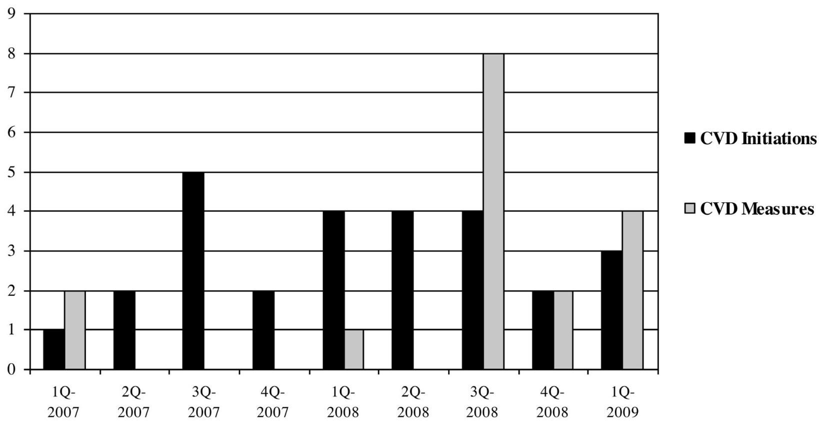
Figure A7.1: *WTO Membership Use of Antidumping (AD), 1995–Q1 2009*

Sources: Data in Panel A7.1a are taken from the WTO member reports to the *Committee on Antidumping* and comprehensively cover the full WTO membership. Data in panel A7.1b were compiled by the author using the Global *Antidumping Database* and cover only 20 using countries. According to data from the WTO, these 20 members initiated 90 percent (89 percent) of all antidumping investigations (new measures imposed) by the WTO membership during 1995–2007. Unlike Figure 7.1, the unit of observation is a WTO member country's AD action over a given product from a single exporting country.

APPENDIX



CVD Historically, by Year: 1995–2008

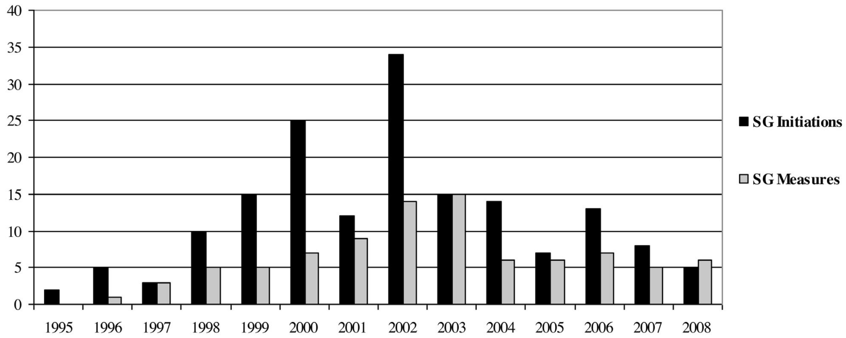


CVD during the Crisis, by Quarter: Q1 2007–Q1 2009

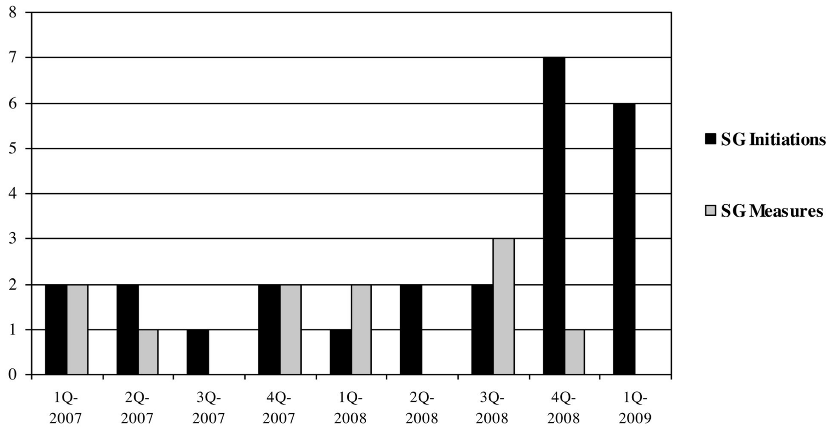
Figure A7.2: *WTO Membership Use of Countervailing Duties (CVD), 1995–Q1 2009*

Sources: Data in panel A7.2a are taken from the WTO member reports to the *Committee on Subsidies* and Countervailing Measures and comprehensively cover the full WTO membership. Data in panel A7.2b were compiled by the author using the *Global Antidumping Database* and cover only 18 using countries. According to data from the WTO, these 18 Members initiated 93 percent (97 percent) of all countervailing duty investigations (new measures imposed) by the WTO membership during 1995–2007. Unlike Figure 7.1, the unit of observation is a WTO member country's CVD action over a given product from a single exporting country.

APPENDIX



SG Historically, by Year: 1995–2008



SG during the Crisis, by Quarter: Q1 2007–Q1 2009

Figure A7.3: *WTO Membership Use of Global Safeguards (SG), 1995–Q1 2009*

Sources: Data in both panels were taken from the WTO member reports to the *Committee on Safeguards* and comprehensively cover the full WTO membership.

APPENDIX

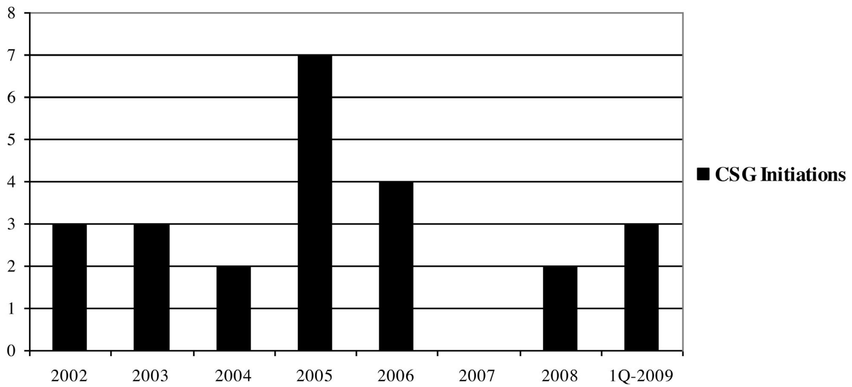


Figure A7.4: *WTO Membership Use of China-specific Transitional Safeguards (CSG), 2002-Q1 2009*

Sources: Data are taken from WTO member reports to the *Committee on Safeguards* and comprehensively cover the full WTO membership to the extent that members report all initiated investigations; these are also supplemented with some information from national government reports.

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Trade Finance in Crisis
Market Adjustment or Market Failure?

JEAN-PIERRE CHAUFFOUR AND THOMAS FAROLE

1. INTRODUCTION

The global economic crisis has had a major detrimental impact on trade. International trade is projected to decline in 2009–for the first time since 1982.[1] There is strong anecdotal evidence that the financial crisis may have reduced the availability of trade finance, and hence the volume of trade that would have otherwise taken place – even in the face of the demand shock. Various estimates have put the size of this trade finance 'gap' in the range of $25–500 billion.[2] This has raised serious concerns in many policy quarters and has led to calls for intervention to reduce the gap in order to avoid deepening and spreading the contagion. Governments and multilateral institutions have responded with a range of programs designed to support the trade finance market through increased liquidity and risk guarantees and insurance. Leaders of the G20 agreed to ensure $250 billion of support for trade finance at their April 2009 summit in London in order to promote global trade and investment.[3]

Notwithstanding this increased activism around trade finance, it remains largely unclear how much of the contraction in international trade may be caused by restrictions in the supply of trade finance and to what degree this represents a legitimate target for intervention. For intervention to be justified, at least three preconditions should be met. First, the scale of the supply gap should be of some significance. Second, the shortfall in the provision of trade finance can be attributed to a structural or temporary market failure. And third, targeted interventions can be designed to achieve the desired response by market participants (that is, supplying trade credit at market-clearing prices) without creating unac-

[1] According to the World Bank's *Global Economic Prospects* (June 2009), the world trade volume in goods and services is projected to decline by 9.7 percent in 2009, with a significantly sharper contraction in trade volumes of manufactured goods.

[2] See, for example: WTO (2008); FIMetrix (2009); IFC Ltd. (2009)

[3] "We will ensure availability of at least $250 billion over the next two years to support trade finance through our export credit and investment agencies and through the MDBs. We also ask our regulators to make use of available flexibility in capital requirements for trade finance". London Summit Communiqué, April 2, 2009.

ceptable moral hazards or subsidising the provision of credit that would have been taken place in any case.

The purpose of this paper is to discuss these issues with a view to addressing the following questions: Is there a trade finance gap and if so what is its scale and nature? Is there a rationale for intervention to support trade finance? And what tools and policies are most fit for purpose to address it?

2. IS THERE A TRADE FINANCE GAP?

By providing critical fluidity and security to enable the movement of goods and services, trade finance lies at the heart of the global trading system (Auboin and Meier-Ewert, 2008). Some 80 to 90 percent of all trade transactions are said to be financed.[4] Trade finance mechanisms exist to support two fundamental aspects of the trading process*: risk mitigation* and *liquidity*.

2.1 What is trade finance?

Appendix 1 outlines the main products typically included in discussions of trade finance. The vast majority of trade finance involves credit extended bilaterally between firms in a supply chain or between different units of individual firms.[5] Banks also play a central role in facilitating trade, both through the provision of finance and bonding facilities and through the establishment and management of payment mechanisms such as telegraphic transfers and documentary letters of credit (LCs). Amongst the intermediated trade finance products, the most commonly used for financing transactions are LCs, whereby the importer and exporter essentially entrust the exchange process (that is, payment against agreed delivery) to their respective banks in order to mitigate counterparty risk.

Complementing the activities of the banks are: export credit agencies (ECAs), which guarantee and insure domestic exporters; private insurers, which provide trade credit insurance, political risk insurance, and bonding facilities; and multilateral development banks (MDBs), which operate formal trade facilitation programs designed to support banks by mitigating risks in new or challenging markets where trade lines may be constrained.

Trade finance differs from other forms of credit (for example, investment and working capital) in several ways, which may have important economic consequences during periods of financial crisis. As noted above, perhaps its most distinguishing characteristic is that it is offered and obtained not only through third-party financial institutions but also through inter-firm transactions. That

[4] Although this range of 80–90 percent is widely reported, the source and evidence for the claim is unclear.

[5] According to messaging data from SWIFT, approximately 90 percent of trade finance occurs through inter-firm, 'open-account' exchange. Estimates from FImetrix (2009) suggest that 10–20 percent of trade finance is composed of cash-in-advance payments (these mainly involve SME buyers, and inordinately in developing countries); 45–80 percent is on open account (of which 30–40 percent is intra-firm), and 10–35 percent is bank intermediated.

inter-firm trade finance is so prevalent is typically explained by certain features that enable trade partners to assess and mitigate risk better than third parties, including an *informational advantage* and the advantage of trust, or e*ncapsulated interest* (Giannetti, Burkart, and Ellingsen, 2007). Relative to a standard credit line or working capital loan, trade finance – whether offered through banks or within the supply chain – is relatively illiquid, which means that it cannot easily be diverted to another purpose. It is also highly collateralised – credit and insurance are provided directly against the sale of specific products or services whose value can, by and large, be calculated and secured.[6] This suggests that the risk of strategic default on trade finance should be relatively low, as should be the scale of loss in the event of default.

Other unique aspects of trade finance may imply greater potential risk. The most obvious being its exclusively international context, which tends to raise the levels of both macro-level risks (for example, exchange rate fluctuations, changes to policy, conflict, political upheaval) and counterparty risk, linked to the greater difficulty of enforcement across borders (Menichini, 2009). Weak cross-border enforcement raises the risk of strategic default on the part of suppliers, creating a problem of 'credible commitment' across borders (Ellingsen and Vlachos, 2009). Finally, the cross-border nature of trade financing means that data on which to assess counterparty credit risk are often limited or non-existent (for example, where there is limited public credit registry coverage or public access to accounts or court proceedings). These risks may be compounded in the case of supplier-extended credit, by the fact that most suppliers operate in 'credit chains', which are vulnerable to shocks, as they can quickly propagate problems across the chain (Kiyotaki and Moore, 1997; Raddatz, 2008).

2.2 The impact of the financial crisis on trade finance

It has become clear that the global economic crisis has many culprits, including amongst others: a prolonged period of loose monetary conditions in the United States, regulatory failure, a policy-induced mortgage crash in the United States, the growth of 'shadow banking' and the use of ever-more complex financial instruments, and greed and herd-like behaviour by investors. The subsequent collapse in confidence in the banking sector can be seen most clearly in the spread of Libor (the interbank reference rate) over T-bills (US Government Treasury bills) in the period that followed the collapse of Lehman Brothers. This spread – which historically was in the range of 10–30 basis points – rose dramatically to over 400 basis points in the second half of 2008. Large-scale government intervention has since brought these spreads down, but they continue to trade at levels well above historical averages.

[6] This is of course not true in all cases. Specific problems occur with products that are perishable (that is, whose value erodes quickly or immediately), that are extremely differentiated (that is, where there is little or no market value outside the intended buyer), and for services (which are not generally able to be collateralised).

Although trade finance has neither been a proximate nor ultimate cause of the financial crisis, it quickly became collateral damage. As the financial crisis unfolded, the availability of trade finance tightened and its cost rose because of growing liquidity pressure in mature markets, and a perception of heightened country and counterparty risks. However, with no comprehensive and reliable data on trade finance available, an overall assessment of trade finance developments in 2008–09 remains difficult. Historical precedents and selected information indicate that—along with global demand—trade finance flows declined in the last quarter of 2008.

Trade finance has tended to be highly vulnerable in times of crisis. During the late 1990s and early 2000s crisis episodes in Argentina, Brazil, Indonesia, Pakistan Korea, Thailand, and other emerging economies, liquidity and solvency problems encountered by local banking systems made it difficult for local producers to get pre- and post-shipment finance, open LCs, obtain advance payment bonds and other forms of domestic trade finance. For instance, bank-financed trade credits declined by about 50 percent and 80 percent in the Republic of Korea and in Indonesia, respectively, in 1997–98. During the crisis episode in Latin America in the early 2000s, trade credits in Argentina and Brazil declined by as much as 30–50 percent (Allen, 2003).

The IMF–BAFT survey of global banks (FImetrix 2009) indicates that 71 percent of banks reported a decline in the value of their LC business, with an overall 8 percent decline in the year to October 2008 (versus 2007), accelerating to 11 percent during the period October 2008 to January 2009. This was significantly greater than the declines for export credit insurance and short-term export credit working capital (4 percent and 3 percent respectively in the latest quarter). Whilst 73 percent of banks recognised the role of falling trade demand on the decline in trade finance lines, more than half also attributed it to a decline in available credit (that is, a decline in supply). Overall, as can be seen in Table 8.1, the IMF estimates that the decline in the value of trade finance transactions has been far less than the decline in export value in the period October 2008 through January 2009.

3. VALUE OF TRADE TRANSACTIONS

Table 8.1: *Decline in Trade Finance Transactions v Decline in Exports, October 2008-January 2009*

	% change, January 2009 v October 2008	
	Trade Finance	Exports
Industrialised	−9%	−26%
Latin America	−9%	−45%
Central Europe	−11%	−40%
Eastern Europe	−13%	−55%
Middle East/Maghreb	−5%	−26%
Emerging E. Asia	−10%	−37%
South Asia	−9%	−13%
Sub-Saharan Africa	−8%	–

In a World Bank survey of 60 global buyers and suppliers in early 2009, 40 percent of companies indicated that foreign sales have been delayed or cancelled due to drops in new orders, and 30 percent due to difficulties in obtaining trade finance (Arvis and Shakya, 2009). Findings from two other World Bank surveys of 400 firms and some 80 banks in 14 developing countries across five regions[7] indicate that although a drop in demand played a central role in explaining the decrease in trade finance flows, 30 percent of firms, especially SMEs, stated that lack of finance on buyers' or companies' parts explain the decline in exports (Malouche, 2009). Evidence of liquidity pressure on trade finance has also been reported by the banks participating in the IFC's Global Trade Finance Program. Major international banks participating in the program have been unwilling to assume a portion of the risk in a particular transaction, leaving the underlying risk to the IFC alone.

Firms most affected are generally highly exposed to the international financial market (for example, Brazil); SMEs that are being crowded out by large firms in accessing trade finance (for example, Chile, Philippines); and firms that are highly integrated in global supply chains (for example, Tunisia, Turkey, India, Indonesia). Firms that are least affected are those in low-income countries with underdeveloped domestic banking systems, especially in sub-Saharan Africa (for example, Ghana). However, the World Bank survey indicates that the biggest financing constraint – particularly for SMEs and firms operating in global supply chains (which generally work through open account methods) is not access to trade credit (for example, LCs) *per se*, but rather pre-export finance. It is here where banks have become particularly stringent in their risk evaluation, particularly with regard to emerging market participants and SMEs. As exporters who normally self-finance are forced by the crisis to seek additional liquidity, this may become the most important inflection point of the trade finance 'gap'.

Perhaps more important than supply alone, the price of trade finance and the need for securing transactions through guarantees and insurance have increased markedly. Tight credit conditions have allowed lenders to drive up interest rates for their loans in many countries, especially in emerging markets. By the end of 2008, trade finance deals were offered at 300–400 basis points over interbank refinance rates, that is, two to three times more than the rate a year earlier. The cost of LCs was reported to have doubled or tripled for buyers in emerging countries, including Argentina, Bangladesh, China, Pakistan, and Turkey. This was confirmed in the IMF–BAFT survey, which found widespread increases in the pricing of all trade finance instruments relative to banks' costs of funds. More than 70 percent of respondents indicated that the price of various types of LCs increased because of an increase in their own institution's cost of funds (80 percent of respondents), an increase in capital requirements (60 percent of respondents), or both.

[7] Indonesia and the Philippines; Turkey and the Ukraine; Brazil, Chile and Peru; Egypt and Tunisia; India; and Ghana, Kenya, Sierra Leone, and South Africa.

Finally, in a recent attempt to disentangle the effects of trade finance from demand shocks using disaggregated bilateral import and export data from the United States, Germany, and Japan, Freund and Klapper (2009) show that the trade in industries more dependent on inter-firm financing with countries more exposed to the crisis has not been affected more than overall trade. This suggests that trade finance has not been more adversely impacted than other types of financing on which firms rely. However, they also find some evidence that, in countries more affected by the crisis, trade in industries that are more dependent on short-term financing, broadly defined, has fallen more sharply. This implies that financial needs have played a role in affecting trade patterns during the crisis. However, the results do not necessarily suggest that trade finance has constrained overall trade growth – rather there has been a substitution away from firms in the most affected countries toward firms in less affected countries in industries with high financial dependence.

These findings reflect the fact that bank-intermediated trade finance is only a very small part of the story. In most cases, exporters are: extending credit within the supply chain with payments made on open account; and funding working capital or pre-export finance through retained earnings. This means that firms for the most part have actually not been as badly constrained by trade finance as one may have anticipated. Yet, the massive drop in export orders over the past six months means that the internal liquidity of these firms is likely to have dried up. So, as trade starts to pick up again, firms that normally self-finance may need to seek a line of credit (working capital or pre-export financing) from banks. And the evidence from the surveys seems to suggest that this type of financing (rather than necessarily LCs and other guarantees) is where banks are becoming more selective and imposing adverse conditions (more collateral required and higher interest rates), particularly on SMEs. While the interbank crisis of confidence may be over by mid 2009, there is still the danger of a second-round effect that could constrain trade and hinder the recovery.

4. IS THERE A RATIONALE FOR INTERVENTION TO ADDRESS A TRADE FINANCE 'GAP'?

A critical question is whether the decline in the supply of trade finance is the result of market and (or) or government failures, and therefore whether there is a rationale for intervention or correction to address them.

A precondition for answering this question is to understand what a trade finance gap is and what could contribute to its existence. First, a decline in demand for trade finance cannot constitute a gap. A drop in trade finance could simply be the consequence of declining trade volumes, as long as these trade declines did not derive wholly and directly from *trade* finance constraints. In fact, the uncertainty brought about by the crisis might actually result in an *increase in demand* for trade finance (at pre-existing price levels), as trading partners resort to more formal, bank-intermediated instruments to reduce the higher expected probabil-

ity of default in open account trade.[8] Indeed, in the recent ICC Survey (ICC, 2009) 48 percent of banks indicated they had experienced an increase in demand for issuance of bank undertakings between the last quarter of 2007 and the last quarter of 2008 (despite stagnant trade volumes). These developments are consistent with the data released by the Berne Union of export credit and investment insurance agencies, which indicate that, in the last quarter of 2008, total new insurance commitments have fallen by much less (7 percent) than trade volumes (20 percent), with medium and long-term commitments remaining constant in volume.

A real 'gap' would only emerge in a situation in which the supply of trade finance is insufficient to clear markets either because it is not being supplied at all (that is, 'missing markets'), or at prices that are temporarily too high to meet demand in the market (that is, 'overshooting markets').

4.1 'Missing markets': insufficient supply of trade finance

Whilst trade finance transactions are dispersed globally, overall volumes are highly concentrated in a few major international banks, several of which (for example, Lehman Brothers) went under in the latter part of 2008. Their business would be expected to be reallocated relatively quickly amongst other suppliers, at least in an efficiently functioning market. However, the severe liquidity constraints and a collective collapse of confidence may, in the short term, mean that alternative banks were unable or unwilling to take on this business. Thus, there might well be a need for some transitory intervention to address this supply gap in the market.

There are a number of reasons why bank deleveraging and risk-adjustment processes in response to the financial crisis might unfairly restrict the supply of trade finance more than other forms of bank credit, despite the fact that trade finance should be a relatively low-risk product line.[9] Part of the problem may lie in the temporary inability of the market to calculate the risks properly – in other words, it is not a problem of risk *per se* but uncertainty.[10] Uncertainty plagues trade finance (at least bank-intermediated trade finance) because of the number and nature of the parties involved – for example, in the case of LCs the bank is reliant on three parties two of which are located in foreign countries.[11] This may not have been perceived as a problem when banks were well capitalised and profits high. However, there is evidence to suggest that the current economic crisis

[8] The economic crisis would be expected to threaten the viability of firms across supply chains, and so would raise the overall probability of default in any inter-firm financed exchange.

[9] Bank deleveraging and risk-adjustment is not in itself a reason for intervention. Indeed, it is a critical process to restore stability and confidence in the financial system over the medium and long term.

[10] Here we refer to the classic distinction that Knight (1921) made between risk – that is, where the probability of an outcome can be calculated mathematically – and uncertainty – that is, where the probability of an outcome cannot be calculated (and so cannot be insured against).

[11] For example, in the case of LCs the bank is reliant on three parties (customer, the trade partner, and the partner's bank) two of which are located in foreign countries.

has resulted in a systematic recalibration of international risk relative to domestic risk. This stems from both real perceptions of higher macro level risks as well as a herd-like 'flight to safety' that works against international transactions.

Unique to this crisis is that it is not just developed country banks lacking confidence in their developing country counterparts, but also the other way round. This collective lack of confidence within the banking system may be squeezing trade finance customers more so than customers of traditional lines of credit, because the most common forms of bank-intermediated trade finance, such as LCs, rely on *interbank* payments. This is particularly problematic for exporters in developing countries, who often lack access to other guarantees (for example, through ECAs and Eximbanks) to cover the risks of non-payment from developed country importers. The problem of inter-bank trust suggests a need for intervention – at the very least in emerging markets – either through using guarantees to restore confidence or through the imposition of institutions to ensure transparency and enforcement.

Information asymmetries in international markets, particularly acute in trade finance due to lack of transparency (Allen, 2003; Auboin and Meier-Ewert, 2008), contribute to the uncertainty problem.[12] In the best of times such information problems raise the risk of adverse selection. But as Ellingsen and Vlachos (2009) point out, the problem of ensuring a 'credible commitment' from borrowers becomes more severe in a liquidity crisis, due to the increased incentive to hoard cash. Extending their argument to the current crisis – characterised by large lending spreads and low returns for most private investors – banks may react by substantially reducing the availability of trade credit and diverting it to credit lines in which the counterparty's incentive to hoard cash is relatively lower. Thus the risk of strategic default is high, particularly so if there is less trust between banks operating across borders. This 'moral hazard', might be contained through intervention aimed at reducing the incentives to divert credit to other purposes.

The short-term nature of trade finance is also an issue. With the liquidity crisis forcing banks to recapitalise as quickly as possible, trade finance credit lines – the majority of which have terms of less than 180 days – are relatively easy to call in and so tend to be the first lines of credit that banks cut. Whilst banks may maximise their own gains by choosing liquidity over loans, in doing so they may fail to take into account the wider benefits to their customers in terms of increased productivity and improved liquidity, and their subsequent spillovers to firms down the supply chain.[13]

Finally, there may be strong political-economy factors which contributed to the insufficient supply of trade finance during the financial crisis. As much of the response to the crisis has taken place at the national level, through central banks

[12] It is normally difficult to get reliable information on the balance sheet of a foreign company – especially an SME – or a foreign bank.

[13] This may be particularly relevant during a recessionary period when spare capacity is likely to be high.

providing liquidity to domestic banks, there is likely to be strong political pressure and moral suasion to use these funds to support domestic lending. Informal requirements for lending locally have been introduced in several countries. Interventions do create distortions, not only domestically but also across borders, leading to various competition effects across segments of the credit system. This suggests the possible need for intervention to re-establish the level playing field and support collective action in this regard.

In the case of inter-firm trade finance, there may also be a situation of 'missing markets'. When firms decide to hold back on extending credit for fear of default, buyers would be forced to pile into the formal, bank-intermediated market. Similarly, as retained earnings that normally fund pre-export working capital dry up in the face of the recession, exporters may be forced to seek extended bank credit lines. This could really exacerbate the gap between market demand and supply of trade finance.

4.2 'Overshooting markets': supply and demand not clearing

The largest piece of the trade finance 'gap' may result not from a lack of demand or supply, but of the two failing to meet – specifically, where the prices at which banks are willing to supply trade finance are too high to clear market demand. Again, there appear to be specific aspects of trade finance which may make it relatively more prone to this form of market failure, particularly during a financial crisis.

On the supply side, systematic recalibration of risk has essentially forced a downward shift in the supply curve for all kinds of credit. If risks were simply adjusting to new market realities, this cost should at least in part be passed on to their customers. Here price rigidities may come into play. The current economic crisis appears to be bringing with it strong deflationary pressure. As a result, market prices for most goods are sticky, giving traders little scope to pass on these costs.

Changes in regulatory regimes (specifically Basel II) may also temporarily affect the efficient functioning of markets – specifically setting the floor price above that which would clear the market. Whilst it is not specific to trade finance *per se*, the way in which Basel II characterises risk (that is, focusing on counterparty risk – normally proxied simply by country risk – rather than performance risk), penalises trade finance as the risk premiums on international transactions tend to be relatively high, despite the low performance-risk of trade finance. The case is aggravated still further for trade involving developing countries, which generally have the highest risk ratings.

Virtually all of the market failures discussed above derive from the severe crisis of confidence affecting markets, leading to greater uncertainty, recalibration of risks, and changed lending behaviour. Such a problem of confidence is generally a transitory phenomenon. Markets are already undergoing an adjustment process in terms of the view that risk is assessed and treated. In any adjustment it is likely that markets will overshoot the equilibrium for a time. In this case, the result is that where markets may have systematically underestimated risk in re-

cent years, they may well be overestimating it in the short term. There may be a case for government intervention that can speed up the adjustment process, or that compensates the short-term losers.

Two final rationales for intervention in support of trade finance lie in the potential multiplier effects inherent in it. Because of the strong interaction effect between bank-intermediated credit and inter-firm credit, a banking sector liquidity shock not only reverberates down supply chains, but subsequently resonates back into the financial system, as a result of increased levels of default (Escaith and Gonguet, 2009). Thus, trade finance may amplify and prolong the initial crisis, particularly in open economies which are integrated in global production networks. At the same time, an easing of the shock (for example through the injection of liquidity or a demand stimulus) can also spread quickly across the chain. But as no individual seller is likely to take into account the cross-supply chain gains fully (including demand as well as liquidity gains) of extending credit, there may be an insufficient provision of inter-firm trade credit along a supply chain.

Second, the complementary nature of trade finance and other forms of firm financing (for example, investment and working capital) suggests that intervention to support trade finance could have a multiplier effect. Ellingsen and Vlachos (1999) point out that because trade credit cannot easily be diverted from production, it actually reduces the likelihood of default on other forms of firm-level financing. Thus, interventions to increase the flow of trade finance may have the effect of reducing the cost of capital more generally, or at least of improving banks' liquidity positions.

5. WHAT IS THE MOST APPROPRIATE APPROACH FOR INTERVENTION TO SUPPORT TRADE FINANCE IN THE CURRENT CRISIS?

5.1 What has been the experience with intervention?

The international community has had significant experience in dealing with financial crises, most recently as a result of the Asian crisis and further emerging markets crises in Latin America, Russia, and Turkey amongst others. As such, a wide range of policies, tools, and programs have been implemented to address problems in trade finance markets, targeted at specific issues such as liquidity, risk perception, and collective action.

Several important lessons can be learned from the successes and failures of past interventions, as drawn from Allen (2003):

- Interventions to support trade finance must be accompanied by macro and structural reforms;
- Where the domestic banking sector is weak, interventions that rely on the sector for intermediation are likely to fail;
- The importance of targeting pre- and post-export liquidity; in the absence of this, there may be no trade transaction to finance;

- The importance of timely implementation of initiatives, including winding them down when markets begin to normalise;
- Ensuring that interventions are designed so that they are used by the specific parties being targeted; and
- Ensuring that pricing is appropriate, balancing between the risks of moral hazard, and failing to complete markets.

Whilst the current economic crisis is still unfolding, a number of domestic and multilateral interventions have been launched (see Appendix 2). National authorities started to intervene to provide blanket liquidity to banks, and targeted trade credit lines and guarantees for exporters that have been cut from trade finance. Governments have also increased their support of ECAs to reflect substantial increases in demand in the wake of the drying up of credit from traditional sources.[14] Development institutions have taken actions to help ease access to trade finance. For example, in response to the financial crisis, the International Finance Corporation (IFC) has, among other actions, doubled its Global Trade Finance Program to $3 billion to facilitate trade by providing guarantees that cover the payment risk in trade transactions with local banks in emerging markets. To deal with the liquidity constraint, the IFC has also introduced a Global Trade Liquidity Program, which, in collaboration with official and private partners, is expected to provide up to $50 billion of trade liquidity support over the next three years. Regional development banks such as the African Development Bank (AfDB), the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), and the Inter-American Development Bank (IDB) have also launched or expanded their trade finance programs.

5.2 Ten principles for intervention to support trade finance in the current crisis

1. Targeted interventions

One clear lesson that has already emerged from this crisis is that any money flowing into the banks – unless it is properly ring-fenced and conditions are attached – is at risk of being used for recapitalisation rather than lending. This can be overcome by asking the banks to set up special purpose vehicles for trade finance, which would be required to use the new liquidity/risk capacity for the sole purpose of trade finance with emerging markets.

2. Holistic response

Without corresponding measures to address wider liquidity issues of banks and to stimulate lending for investment and working capital purposes, neither the

[14] Amongst those that have launched new programmes are: the United States, Germany, France, the Nordic countries, Hong Kong, China, and Chile. These include some specific bilateral agreements to provide targeted funding through Exim banks, including US$20 billion between the United States and China and US$3 billion between the United States and South Korea.

banks nor their customers who participate in the trade finance market will be healthy enough to do so.

3. Integration with existing institutions

Most trade finance operates within fairly well-established institutional relationships using simple products, such as LCs. Effective interventions in past crises have generally worked within these existing market practices and documentation, and did not seek to reinvent mechanisms or to apply unduly complicated documentation or practices.

4. Collective action

The interdependencies in the financial system are more than ever demanding a coordinated effort to revive trade finance flows. Coordinating national interventions could send a powerful signal to market participants that could help restore confidence and eventually lower the overall cost of public intervention. Coordination at the regional level can also be effective. For example, APEC established the Asia-Pacific Trade Insurance Network at the end of 2008 to facilitate regional trade. The international community appears to have recognised the importance of such coordination, and the initiatives coming out of the G20 meeting in London have adhered to this approach.

5. Addressing both risk and liquidity

The current crisis requires interventions that address real liquidity constraints (for banks and firms), as well as those that perceived escalation of counterparty risk. This may involve a combination of ring-fenced funding to support trade finance loans, as well partial guarantee programs – like the IFC's Global Trade Finance Program – which help offset the heightened risk premium in the current market, and may be effective to catalyse trade finance lending.

6. Target emerging markets; recognise the importance of developed market banks

Without attention to international banks' involvement in trade finance and acknowledging their huge distribution power and networks as fundamental parts of the global supply chain, initiatives which are devised to address the crisis may be too fragmented to have more than a marginal impact. Any new risk capacity should be distributed by institutions having the necessary processing capacity and technical expertise. As such, financial institutions in developed markets will be key players.

7. Promoting inter-firm credit

There is scope for financial institutions and enterprises to promote other sources of short-term financing, particularly for the large share of the market involved in integrated global supply chains. One such instrument that may be well-suited

to the heightened risk environment is factoring, which involves the outright purchase of an exporter's invoices at a discount rather than the collateralisation of a loan. While still a relatively small source of credit in emerging markets, the crisis could be an opportunity to expand factoring in both low-income and emerging countries.

8. Level playing field in terms of risk weight

As a result of Basel II, market dynamics, and domestic political pressures linked to bank bailouts, banks are increasingly going to give preference in their capital management processes and lending decisions to either the domestic customers or their customers with a favourable risk profile. One way to offset the risk handicap that trade finance counterparties in emerging markets incur as a result of this is to provide partial risk guarantees from a AAA-rated institutions, along the lines of the programs offered by the MDBs. In the short term at least, it may also be helpful to promote continued flexibility in the implementation of Basel II risk weighting in order to give some relief to trade finance.

9. Improving transparency

The lack of availability of loss data for trade finance transactions as well as the 'one size fits all' approach by participants that all trade is low risk, is a major factor in the specific problem of uncertainty in the trade finance market. This can only be remedied by a concerted effort on the part of all the major trade finance banks to collaborate in the collation of default and loss data so that appropriate relief can be argued with regulators and BIS. The creation of a 'Berne Union' of banks forum which allows regular sharing of such data confidentially could be a potential long-term solution. In inter-firm credit markets, extending 'public credit registers' and voluntary exchange mechanisms to developing countries, where these systems are often still being designed, and promoting the sharing of this information across trading countries could be an important long-term solution.

10. Avoiding moral hazards and wasteful subsidies

Achieving the desired aims of stimulating greater trade finance lending is a significant enough challenge. Doing so without creating substantial moral hazards or subsidising 'winners' is an even greater one. This challenge can be partly addressed through targeted programs that restrict access to banks and firms who really need them. However, experience has shown that achieving this often results in complicated programs that end up being too cumbersome and costly to be taken up in the market. Among the practices which have been shown to be effective in limiting moral hazards and wasteful subsidies are the limiting of the timeframes of programs to avoid crowding out commercial banks, and sharing rather than fully underwriting risk.

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APPENDIX 1: OVERVIEW OF TRADE FINANCE PRODUCTS

Table A8.1:

Category	Product	Description
Inter-firm/supply chain financing	Open account	• Contract is settled between importer and exporter without third-party security or risk management arrangements, either directly or (most commonly) through transfers between their banks; one party (normally the exporter) extends credit by way of accepting payment after a certain period (usually 30–90 days).
'Traditional' bank financing	Investment capital	• Medium-term finance for investment in the means of production (for example, machinery).
	Working capital	• Short-term finance provided to cover ongoing costs (addressing mismatch in timing between cash receipts and costs incurred) including payment of suppliers, production, transport costs, etc.; also used to cover risks of (or real) delays in payments, the effects of currency fluctuations, etc.
	Pre-export finance	• Similar to working capital but bank takes a security interest in the goods being shipped and a right to receive payment for those goods directly from the importer; typically used for commodity production.
Payment mechanisms and liquidity	Letter of credit-usance	• Provided by importer's bank to exporter's bank; when exporter fulfils LC conditions the relevant documents of proof are submitted to the exporter's bank who submits them to the importer's bank, who remits funds to exporter's bank which then pays exporter (importer subsequently remits funds to i porter's bank).
		• This is designed to mitigate the counterparty risk inherent in open account transactions.
	Letter of credit-usance	• Operates similarly to LC – sight but is designed for contracts where payment by an importer is made in instalments after delivery.
	Supplier credit	• Extended or deferred payment terms offered by the supplier to the buyer, but typically linked with bank financing to enable an exporter to receive cash on delivery (for example, factoring)
	Buyer credit	• Term financing provided to finance cash payments due to supplier
	Countertrade	• Addresses liquidity (in particular, access to foreign exchange, and so is particularly relevant in emerging economies) by promoting two-way trade of equivalent value merchandise (for example, barter, buy-back, counter-purchase)
	Factoring and forfaiting	• Factoring is a financial service offered that purchases an exporter's invoices or accounts receivable at a discount and assumes the risk of non-payment; addresses both liquidity and risk mitigation.
		• Forfaiting is similar to factoring but typically involves medium-term accounts receivables for exporters of capital goods or commodities with long credit periods.

Risk management	Advance payment guarantees	• Security provided to importer when exporter requires mobilisation payment; this is usually a matching amount callable on demand.
	Performance bonds	• Security provided to importer (normally in the case of capital goods export), callable in the event of exporter's failure to perform (compensates for costs of finance, re-bidding, etc.)
	Refund guarantees	• Security provided to importer when importer is required to make stage payments during manufacturing by the exporter (normally in the case of large capital goods export), callable in the event of non-delivery of goods.
	Hedging	• Security (for example, through a financial instrument issued by a bank) to offset market (rather than counterparty) risks, including fluctuations in exchange rates, interest rates, and commodity prices.
Export credit insurance/ guarantees	Export credit insurance	• Insures exporters against a range of risks including: non-payment, exchange rate fluctuations, political risk, etc.; Can be used to securitise other forms of trade and non-trade finance from banks
	Export credit guarantees	• Instruments to protect banks providing trade finance; facilitates the degree to which banks can offer trade finance products (for example to SMEs without sufficient export track records)

APPENDIX 2: OVERVIEW OF TRADE FINANCE MEASURES TAKEN BY GOVERNMENTS TO MITIGATE THE IMPACT OF THE TRADE FINANCE CRISIS, AS OF APRIL 2009

Governments are taking measures to make trade finance more accessible and affordable and also to support industries through potentially trade-distorting measures. With the liquidity crunch, international traders are requiring more secured means of payments than open accounts, making extra demand for documented transactions (for example, LCs) and guarantees. SMEs in developing countries are particularly challenged in coping with the rapidly changing risk landscape.

Table A 8.2: *Summary*

Country	Trade Finance Measures
Argentina	✓
Brazil	✓
China	✓
Ecuador	✓
EU	✓
France	✓
Finland	✓
Germany	✓
Italy	✓
Netherlands	✓
Norway	✓
Portugal	✓
Indonesia	✓
India	✓
Israel	✓
Japan	✓
New Zealand	✓
Korea	✓
Serbia	✓
Taiwan	✓
Thailand	✓
US	✓
Vietnam	✓
ASEAN, Japan, China, Korea	✓
ADB	✓
AfDB	✓
G20	✓
IDB	✓
Islamic Development Bank	✓
World Bank	✓
IMF	✓
EBRD	✓

Note: Trade in finance includes loans and guarantees forex allocations, subsidies, and other government financial support, including tax reductions and rebates.

Table A8.3:

Country	Trade Finance Measures
Argentina	**March 2009:**
	Action: introduce new facility that would allow the central bank to offer repurchasing agreement contracts in dollars to allow banks to use their foreign-currency deposit. It is expected that $4 billion in trade finance would be available as a result of the operation.
Brazil	**October 2008:**
	Action: Brazil's central bank issued $1.62bn (£940m) in six-month loans on Monday in an attempt to provide relief to exporters.
	December 2008:
	Action: The Central Bank sold $1.96 billion on offer in a dollar repurchase agreement auction aimed at increasing trade finance lines that have been squeezed by the global credit crisis. The bank sold the repos at 2.382 per dollar and repurchased on Jan. 16, 2009 when participating banks provided guarantees that they used the funds to extend trade financing to exporters.
	February 2009:
	Plan: Brazil's central bank will offer up to $1 billion in dollar repurchase agreements in auction aimed at increasing trade finance lines squeezed by the global credit crunch.
China	**December 2008:**
	Plan: Exporters will be able to increase their advances on foreign-currency payments to 25 percent from the current 10 percent; importers' quota for deferred foreign-currency payments also rose to 25 percent from 10 percent.
	January 2009:
	Plan: HK will seek legislative approval by late January for the government to guarantee banks' issuance of $12.9 billion worth of letters of credit for exports.
	February 2009
	Action: Suzhou Industrial Park provided a special guarantee fund of 50 million yuan in the support of processing trade in surrounding areas of SIP
	February 2009:
	Action: State Administration of Foreign Exchange (SAFE) will encourage trade credit and cross-border financing, and take steps to match these actions with proper risk management
	December 2008:
	Action: Hong Kong: Under a time-limited $100 billion Special Loan Guarantee Scheme, the maximum amount of loans that each enterprise may obtain is $6 million, within which $3 million can be used as a revolving credit line, such as a commercial overdraft and a letter of credit. All companies except listed companies may apply.
	March 2009:
	Action: Hong Kong Export Credit Insurance Corporation has introduced a series of measures to strengthen its support for SMEs during the current financial turmoil. The key ones are as follows: • Higher insurance cover for exports • Higher insurance cover for emerging markets • Annual Policy Fee Waiver • Expediting the processing of small credit limit applications • Free credit checks

	April 2009:
	Action: China will support the financing of global trade by buying the private bonds of the International Finance Corporation.
Ecuador	**November 2008:**
	Action: a 'help package' for the external sector, including measures to facilitate easier access to credit for the export sector, tariff increases, and important restrictions
EU	**January 2009:**
	Plan: The European Bank for Reconstruction and Development plans to increase its trade finance facility to 1.5 billion of euro from 800 million.
France	**December 2008:**
	Action: Announcement of the provision of credit guarantees to car makers under the provision that production will not be shifted.
Finland	**January 2009:**
	Action: Finland tripled export credits to 3.7 billion Euros.
Germany	**January 2009:** **Plan:** discussing the final details for the approval of a 100 billion German Fund of credit guarantees to help cash-starved businesses.
Indonesia	**December 2008:**
	Action: issued a trade financing policy that would guarantee exporters from possible financing failures, along with income tax reductions for certain business sectors.
India	**November 2008:** **Action:** The RBI more than doubled the funds it makes available for banks to refinance export credit at favourable interest rates to Rs220bn ($4.5bn, €3.8bn, £3bn). November 2008: **Plan:** The government is firming up a proposal to expand the resource base of the Export Import Bank of India that provides credit to traders. The government is also considering providing a special line of credit for the ExIm Bank. These efforts are aimed at generating nearly $10 billion which the bank can deploy for lending to the export sector.
	February 2009
	Action: Reserve Bank of India has announced that it would raise interest rates for export credit. Banks' costs of raising funds abroad have increased, because of which they are finding it difficult to extend credit within the current interest rate ceiling.
	February 2009
	Action: RBI further raised the ceiling on export credit in foreign currency to Libor (London inter-bank offer rate) plus 350 basis points. However, banks will not levy any other charges, like management fees, service charges, etc. By increasing the ceiling over Libor that banks can charge from exporters, RBI has ensured that banks do not reject forex credit applications of exporters simply due to the fact that such loans could be economically unviable due to the high cost of financing of foreign currency funds. As a result, while exporters will have to pay higher interest, they will also be able to get higher amount of credit.
Israel	**January 2009**
	Action: Bank of Israel is operating an expansionary interest-rate policy, lowering rates to 1 percent; called upon the government to ease criteria for receiving insurance coverage for export-credit transactions offered by Ashra, the Israel Export Insurance Corp. Ltd., which is fully owned by the government.
Italy	**January 2009:**
	Action: Italian central bank (Banca d'Italia) has just created a Collateralised Interbank Market, where the Banca d'Italia will serve as the universal counterparty, guaranteeing settlement in case of default.

Japan	**November 2008:**
	Plan: Japan has proposed an Asia-Pacific trade insurance network for reinsurance cooperation among export credit agencies in the region to facilitate trade and investment flows during the current financial crisis
	January 2009:
	Action: Japan will hand out $17 billion in development aid to other Asian countries to help them to face the global financial crisis.
	March 2009
	Action: Japanese government will dip into $1 trillion worth of foreign currency reserves to lend dollars to Toyota, Sony, and other struggling exporters.
	March 2009
	Action: The Japan Bank for International Cooperation plans to provide $6 billion for developing countries; and Nippon Export and Investment Insurance will supply an additional $16 billion in trade insurance coverage.
Netherlands	**January 2009**
	Action: For exports to East European states such as Russia, Kazakhstan and the Baltic states, where commercial export loan insurance is no longer available, the government will issue risk cover so that trade remains possible. It will also guarantee 50 percent of company loans up to EUR50 million 'to ensure that businesses have access to sufficient capital to maintain production and investments'.
New Zealand	**February 2009**
	Action: New Zealand Export Credit Office's (NZECO) will provide a short-term trade credit guarantee to exporters and their banks where overseas buyers are offered repayment terms of less than 360 days to ensure that exporters have the means to continue to accept orders that in the current environment might otherwise not occur.
Norway	**November 2008**
	Action: The Norwegian state would loan up to 50 billion kroner (US$ 7.2 billion) to cash-strapped export credit institution Eksportfinans.
Pakistan	**November 2008:**
	Plan: The Central Bank will provide 100 percent refinancing to banks against export finance provided by them to exporters under Part I of the Export Finance Scheme (EFS). Earlier, the State Bank was providing export finance to the banks up to 70 percent. Export finance already provided by banks under Part I of EFS from own sources at the ratio of 30 percent and outstanding as on October 31, 2008 will also be refinanced by the State Bank for the remaining period of individual loans.
Portugal	**December 2008**
	Action: 200 million Euro credit line for auto and car parts exporters.
	January 2009
	Action: The Portuguese government has approved export credit support mechanisms worth 2 billion Euros to rejuvenate economic activity and exports. The sum will be divided equally to support sales to OECD and non-OECD markets.
South Korea	**November 2008:**
	Plan: The Ministry of Finance and Strategy will provide $6 billion to companies who seek the export finance and the payment for the import of commodity. The ministry will spare $6 billion from $20 billion that it decided to lend via competitive bid with no securities.
	December 2008:
	Plan: raise the guarantee ratio and guarantee limit for the export fund of small- and medium-sized enterprises, respectively up to 100 percent and 10 billion won.

	March 2009:
	Plan: Export-Import Bank of Korea (KEXIM) plans to double the amount of trade financing to local SMEs by providing $13 trillion won ($8.44 billion) in trade financing to small local trading companies, mostly exporters, in 2009, double the $6.5 trillion won provided in 2008.
	March 2009:
	Plan: State-run Export-Import Bank of Korea plans to provide $4 trillion won to help local ship parts makers ease liquidity problems.
Serbia	**January 2009:**
	Action: The government earmarks RSD 122 billion for boosting production, export in 2009. Exporters will have priority when the funds are allocated and will be granted loans for specific export projects.
Taiwan	**December 2008:**
	Plan: Taiwan cabinet approved a 8.53 billion TWD export stimulus program that will extend until the end of 2012 will help local exporters garner at least 540 billion Taiwan Dollars of overseas contracts a year.
Thailand	**November 2008:**
	Plan: The ExIm Bank will seek 12.7 billion baht in funds from the government to help support a new soft-loan program for exporters. The bank would also petition the Finance Ministry for funds to support low-interest loans for exporters.
	February 2009:
	Action: The Council of Economic Ministers endorsed the Export-Import Bank of Thailand and the Small Business Credit Guarantee Corporation to raise capital worth a combined 8 billion baht to enable them to extend more credit to both exporters and SMEs' entrepreneurs worth a combined around 200 billion baht to further turning around local economy.
US	**December 2008:** **Action**: The US ExIm Bank
	i) increased access to direct lending and working capital loan guarantees; ii) a provision that allows companies that produce goods or services sold to US companies, and subsequently exported, to apply for working capital loans guaranteed by the ExIm Bank; iii) increase from 10 to 100 percent the amount of a working capital loan guarantee available for these indirect exporters; iv) covering warranty letters of credit up to 20 percent of the loan amount or $1.5 million, whichever is lower, for a term of 12 months. This is a tripling of the previous ceiling of $500,000.
	December 2008:
	Action: United States and China Announce $20 billion in Finance Facilities that will create up to $38 billion in annual trade finance to assist global trade.
	March 2009:
	Action: Ex-Im Bank , which traditionally insures only loans made by private banks, is lending money directly to non-American buyers of American products, exercising a legal authority that it has but almost never uses.
	March 2009:
	Plan: The United States is working with the World Bank and other countries to boost trade financing; specific amount will be determined later.
	April 2009:
	Action: The US Ex-Im Bank will grant four Angolan banks at least US$120 million in credit to cover imports from the United States. The credit line will be granted to the African Investments Bank, Angola's Foment Bank, Angolan Savings and Credit Bank and Angola's Espirito Santo Bank.

Vietnam	**December 2008:** **Plan:** apply a more flexible exchange rate to facilitate export activities. They will also apply financial policies, including tax reduction and exemption to assist enterprises.
ASEAN **Japan** **China** **South Korea**	**February 2009:**
	Action: Asian nations will form a $120 billion pool of foreign-exchange reserves that can be used by countries to defend their currencies in an expansion of efforts to battle fallout from the global financial crisis.
ADB	**April 2009:**
	Action: The Asian Development Bank has expanded its Trade Finance Facilitation Program (TFFP) to $1 billion, a move that could generate up to $15 billion in much-needed trade support by the end of 2013.
AfDB	**March 2009:**
	Action: The AfDB established a US$ 1 billion Trade Finance Initiative (TFI), which will be implemented in phases. The Bank looks to launching in a first phase, a new line of credit for trade finance of US$500 million to enable commercial banks and development financing institutions in Africa to help trade financing operations.
IDB	**October 2008:**
	Action: The IDB has launched liquidity facilities for Latin America and the Caribbean, in a new credit line worth $6 billion. The aim is for the funds to be made available to domestic firms via commercial banks that may face transitory difficulties in accessing foreign and inter-bank credit lines as a result of the financial crisis in the United States and Europe. In addition, the Andean Development Corporation (CAF) announced a liquidity facility of $1.5 billion and the Latin American Fund of Reserves (FLAR) offered $1.8 billion as part of its liquidity arrangements.
	January 2009:
	Action: The IDB is increasing its Trade Finance Facilitation Program (TFFP) limit from $400 million to a maximum of $1 billion. It will also add loans to its current offering of guarantees. It will support non-dollar-denominated trade finance transactions to address the growing demand for transactions denominated in other currencies, especially in Euros.
G20	**April 2009:**
	Action: G20 countries will pledge US$250 billion to assist trade finance over the next two years. The amount will be channelled through export-credit and investment agencies, and through international development banks such as the World Bank.
Islamic Development Bank	**April 2009:**
	Action: The Islamic Development Bank has signed a Mudaraba agreement with a newly formed Islamic trade finance institution to manage a $1 billion fund to boost trade in the Organisation for Islamic Conference (OIC) member countries.
World Bank	**November 2008:** **Action:**
	i) The IFC plans to double its Global Trade Finance Program from US$1.5 billion to US$3.0 billion. The trade guarantees issued under the program will have an average tenure of six months, thereby supporting up to US$18 billion for short-term trade finance over the next three years. The expanded facility would benefit participating banks based in 66 countries, including some of the world's 78 poorest countries. The program offers banks partial or full guarantees covering the payment risk in trade-related transactions. ii) The IFC plans to launch a Global Trade Liquidity Program Of $6 to 8 billion to address the liquidity constraint on global trade finance.

	December 2008:
	Action: announced the creation of a $ 2 billion fast-track facility to speed up grants and long-term, interest-free loans to help the world's poorest countries cope with the impact of the global financial crisis. The facility would be based on strong country analysis focusing on: (a) the impact of the financial crisis on household welfare, growth, capital flows, financial sector, trade finance, infrastructure development, employment, balance of payments, and government budget, financing, and debt sustainability; (b) government plans for policy response; and (c) financing needed to address the impacts while maintaining expenditures in key sectors, including the social sectors and infrastructure.
	January 2009:
	Action: Armenia will receive at least $525m in fresh low-interest loans from 2009 through 2012 from WB. On top of that, it will get separate assistance from the bank's commercial arms, the International Finance Corporation and the Multilateral Investment Guarantee Agency, which could raise the total to $800 million.
	March 2009:
	Action: World Bank unveiled plans to launch a $50 billion fund to help finance trade flows.
	April 2009:
	Action: The Stanbic Banking Group has received $400 million from the International Finance Corporation (IFC) to support trade finance in 17 African countries, including Tanzania.
IMF	**November 2008:**
	Action: A 24-month standby loan of 12.3 billion Euros ($15.7 billion) for Hungary A package worth about 12.9 billion Euros for the Ukraine
EBRD	**December 2008:**
	Action: EBRD disburses first factoring loan in Ukraine by lending to Ukreximbank. The bank signed a factoring finance facility with the EBRD Trade Facilitation Programme earlier this year of up to $10 million to finance sales by small and medium-sized producers, importers, and traders across the country. Through factoring, Ukreximbank provides its corporate clients with an additional way to obtain trade finance without having to mortgage property. Factoring – the purchase, administration, and collection of short-term accounts receivable by a financial intermediary – is a fast and flexible method of improving a company's cash flow. January 2009:
	Action: increase Trade Facilitation Program's budget from €800 million to €1.5 billion to boost trade with and within Eastern Europe, Central Asia, Russia, and the Ukraine. February 2009:
	Action: committed 6 billion Euros to financial institutions and in trade finance for East and Central Europe

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9

The Implementation of the U.S. Stimulus Package: A Preliminary Assessment of the Consequences for International Commerce

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1. INTRODUCTION

In terms of macroeconomic policy the response by governments to the current sharp global economic downturn has been markedly more aggressive than that executed during the Great Depression. Monetary and fiscal policies have been substantially relaxed and many governments have borrowed heavily in their attempts to pump aggregate demand into national economies. The so-called stimulus packages that have been enacted over the past year or so are in addition to the built-in fiscal stabilisers that cushion economies during cyclical downturns. Table 9.1 reproduces a recent summary by the Organisation for Economic Co-operation and Development (OECD) of the magnitude of the fiscal stimulus packages undertaken by its members (OECD 2009). The size of the United States' stimulus package stands out in comparison to its OECD peers, although its scale is on a par with that of China's.

Macroeconomic policymakers and analysts are not the only ones interested in the impact of fiscal stimulus packages. The potential cross-border knock-on effects of government procurement procedures as well as the potential gains to both buyer and seller when foreign firms win government contracts account for trade policymakers' and researchers' interest in initiatives involving substantial changes in government outlays on goods and services. These considerations have been recognised in many trade accords, both multilateral and regional, where signatories have accepted obligations to open part of their government procurement markets and to limit their choice of state purchasing practices.

[1] I thank Gaspar Frontini and other participants in the World Bank-CEPR joint conference on 25-26 May 2009 for their comments on an earlier draft of this paper and on the associated presentation.

Table 9.1: *The Absolute Size of Fiscal Packages (Revenue and Spending Measures): 2008–2010*

	(absolute $US million)
United States	804070
Germany	107789
Japan	99992
Canada	61551
Spain	56754
Australia	45673
Korea	42667
United Kingdom	38003
France	18568
Netherlands	13367
Sweden	13109
Denmark	8668
Finland	8575
Belgium	8016
Czech Republic	6500
New Zealand	5404
Poland	5145
Austria	4600
Switzerland	2486
Luxembourg	1968
Portugal	1963
Slovak Republic	35

Source: Note from original source (OECD 2009, Table 1): "This information is based on information up until 24 March 2009. The figures include only discretionary fiscal measures in response to the financial crisis. Estimates provided here do not include the potential impact on fiscal balances of recapitalisation, guarantees, or other financial operations. They also exclude the impact of a change in the timing of payment of tax liabilities and/or government procurement, a popular measure in several countries. When applying the accrual principle, such measures are not reflected as part of the stimulus packages. Still, they affect fiscal balances measures on a cash basis and may have an impact on the economy".

These data capture the impact of fiscal packages and may not reflect all the measures introduced to boost activity. In particular, recapitalisation operations and increases in public enterprises' investment are not included. For further details on how the stimulus packages have been identified, see the OECD *Interim Economic Outlook*, March 2009.

At times of considerable macroeconomic strain when governments are desperate to revive national economies, such as now, a tension of interest to trade policymakers arises, namely, that between a government adhering to its international commitments and pursuing fiscal stimuli that seek maximum domestic short-run advantage. These episodes might reveal the extent to which existing international disciplines on government procurement 'bite', the manner and extent to which governments attempt to circumvent lawfully their international obligations, and implications of discriminatory state purchasing practices for trade and investment flows.

Three other factors account for current interest in the commerce-related implications of fiscal stimulus packages. First, the scale of these packages repre-

sents a substantial injection of demand into national economies, with the potential to shift a greater share of national demand towards domestically produced goods and services. The question then arises as to whether the short- and longer-term implications for trade flows are substantial and, in turn, whether this is likely to trigger retaliation by trading partners.

Second, in an era of considerable international outsourcing, the manner in which imported parts and components are treated in any revised national procurement regulations could have considerable effects on all those along the supply chain, implicating many nations' commerce. In turn this raises the question as to whether domestic firms that have invested considerably in international supply chains will lobby against discriminatory state purchasing rules and whether their opposition is decisive.

Third, the current disciplines in international trade agreements are, to put it mildly, incomplete in terms of government entities covered, product and services covered, and the instruments of procurement policy. Existing disciplines have tended to ban the more transparent forms of discrimination in procurement policy, so the question arises as to whether even murkier means are now being used to favour national firms, however the latter are defined. This in turn raises questions about what information trade policy analysts and ministries need to track, as well as for the form, feasibility, and merits of expanding public procurement disciplines in trade accords.

In this paper the implementation of the United States' *American Recovery and Reinvestment Act*, that was signed into law on 17 February 2009, is considered in some detail. Readers may recall that the enactment of this stimulus package was very controversial both inside and outside the United States. As far as the latter was concerned, many trading partners expressed concerns about the so-called 'Buy American' provisions in the proposed legislation.[2] The focus in this paper is not on the trading partners' criticism or the US Administration's immediate response, but on the subsequent implementation of the Act. The discussion here, therefore, will seek to shed light on the trade policy ramifications of the implementation of the Act. Particular attention will be given to the manner in which legislative text has been converted into administrative guidance, not just to Federal Departments and Agencies but also to sub-national levels of government. The growing body of qualitative evidence of the impact of this guidance is discussed, as well as the very recent retaliation by certain sub-national authorities in Canada.

While the trade-related questions raised by recent fiscal stimuli are far-reaching, our ability to answer them fully at this time is surely constrained. Modesty is needed in drawing conclusions, especially as only a small fraction of the total outlays associated with most fiscal stimulus plans have actually been spent. Moreover, in some important jurisdictions the procurement rules used to disperse extra

[2] An excellent contribution to the debate over the merits of the Buy American text proposed in the bills before the US House and Senate is Hufbauer and Schott (2009).

outlays have not been finalised. The picture, so to speak, may look much different in 18 months time. At most we hope to identify interesting and significant trends and policy questions, bearing in mind that our provisional findings may need to be revised over time.

The remainder of this paper is organised as follows. A detailed examination of the current US fiscal stimulus package is presented next. After that the reaction of America's trading partners and firms are considered. Implications for policymaking (such as they are, being subject to the caveats mentioned earlier) are presented in the concluding section of the paper.

2. THE IMPLEMENTATION OF AMERICAN RECOVERY AND REINVESTMENT ACT 2009 (ARRA)

Many governments, both developing and industrialised, have implemented stimulus packages. Few, however, did this on such a scale as the United States. Nor did the enactment of their stimulus packages generate as much commentary as that of the United States. It may be recalled that, for different reasons, the bills before the US House and the US Senate were widely condemned for their discriminatory (Buy American) provisions. Several trading partners went so far as to claim that if not amended, the enactment of these bills could lead to 'trade war'. The intervention of President Obama and his administration's officials was said to have reassured the US trading partners that the implementation of these provisions would be consistent with that of the obligations that the United States had taken on in international trade agreements relating to government procurement. In this section the implementation of the ARRA is considered in some detail, in part to highlight the many ways in which international commerce can be implicated by a sizeable national stimulus package. In turn, this may have implications for conducting analyses of other nations' stimulus packages and for the possible strengthening of government procurement accords in trade agreements.

Coming up with a comprehensive assessment of the impact of this legislation is simply not possible at this time. This may be a disappointment for some readers, but there are good reasons for not jumping to conclusions. According to the *Quarterly Report To The President on Progress Implementing The American Recovery and Reinvestment Act of 2009*, by 5 May 2009 (that is, 77 days after the ARRA was signed into law) just over $88 billion had been 'obligated'[3] by US federal agencies. Of that sum, only $28.5 billion had been actually spent. A further $15.9 billion of funds covering medical assistance programs had been paid to US states and territories. More recently, according to www.recovery.gov [4], by 3 July 2009, $174.91 billion of spending was 'available' and $60.43 billion had been spent. Bearing in mind that not all of these funds were appropriated to spend on

[3] According to this document an "obligation" is "a binding agreement (for example, a contract) that will result in outlays, immediately or in the future" (page 4, footnote 1).

[4] A website created by the US Federal Government to monitor and report on the implementation of the ARRA.

goods and services, the actual increase to date of the size of the US government procurement market is smaller. Furthermore, as will become clear, the Federal government has not finalised its procurement regulations, including those relating to the controversial Buy American clauses, and so the ultimate degree of discrimination against foreign firms remains to be known. Finally, given that the ARRA appropriates a grand total of $787 billion over many years, for all of these reasons it is premature to draw any strong conclusions about the overall impact of the ARRA on trade and investment flows from the first 150 days or so of its existence.

Given the focus on the potentially discriminatory aspects of the ARRA, it makes sense to start by quoting in full the text referring to the Buy American provisions found in the enacted legislation.

"Sec. 1605. *Use of American Iron, Steel, and Manufactured Goods.*

(a) None of the funds appropriated or otherwise made available by this 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 United States.
(b) Subsection (a) shall not apply in any case or category of cases in which the head of the Federal department or agency involved finds that:
  (1) applying subsection (a) would be inconsistent with the public interest;
  (2) iron, steel, and the relevant manufactured goods are not produced in the United States in sufficient and reasonably available quantities and of a satisfactory quality; or
  (3) inclusion of iron, steel, and manufactured goods produced in the United States will increase the cost of the overall project by more than 25 percent.
(c) If the head of a Federal department or agency determines that it is necessary to waive the application of subsection (a) based on a finding under subsection (b), the head of the department or agency shall publish in the Federal Register a detailed written justification as to why the provision is being waived.
(d) This section shall be applied in a manner consistent with the United States' obligations under international agreements".

This section leaves many terms undefined, for example, 'manufactured goods'.[5] Moreover, it is not particularly clear whether parts, components, or services procurement must adhere to these provisions. In addition, the terms under which the exceptions could be invoked has not been spelt out. The Conference Report produced by the relevant House and Senate members did shed some light on the Section 1605(d), the all-important 'concession' that placated the US trading partners. The Conference Report notes on page 516:

[5] This is significant, as prior Buy American legislation did not cover manufactured goods. It is, therefore, important that goods are now covered by Section 1605 that were not covered by the prior legislation.

"Section 1605 provides for the use of American iron, steel, and manufactured goods, except in certain instances. Section 1605(d) is not intended to repeal by implication the President's authority under Title III of the Trade Agreements Act of 1979. The conferees anticipate that the Administration will rely on the authority under 19 USC 2511(b) to the extent necessary to comply with US obligations under the WTO *Agreement on Government Procurement* and under US free trade agreements and so that section 1605 will not apply to least developed countries to the same extent that it does not apply to the parties to those international agreements. The conferees also note that waiver authority under section 2511(b) (2) has not been used".

Thus, the conferees for this legislation deliberately put WTO GPA members, signatories of free trade agreements with the United States, and least developing countries in a privileged position over other US trading partners.

The ARRA also contained two other clearly discriminatory provisions. First, a $2 billion appropriation was made for advanced batteries and components 'produced in the United States'. Second, the appropriations made available to the US Department of Homeland Security to acquire a wide range of products, and items listed under Section 604(b) cannot be used "if the item is not grown, reprocessed, reused, or produced in the United States".

It fell to various US federal offices to promulgate the regulations that determine the manner in which this legislation is implemented by those undertaking ARRA-funded projects. These offices being the Office of Management and Budget (OMB), the agencies that propose the Federal Acquisition Regulation (FAR), and insofar as certain environmental projects are concerned, the Environmental Protection Agency (EPA). Each is discussed in turn and the question that arises is how strictly they interpret the legislative mandate given by Section 1605 of the ARRA, and the extent to which the international obligations of the United States are prioritised in the implementation of regulations.

On 3 April 2009 the OMB issued *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, updating a previous document issued on 18 February 2009. The *Updated Implementing Guidance* applied "...to all Federal departments and agencies involved in or impacted by the Recovery Act or which otherwise perform services for agencies that receive such appropriations" (,page 5). Amongst the guidance offered in this document, Section 1.6. related to the other policy objectives that a US agency should consider in determining how to use the funds provided for under the ARRA. It is noteworthy that adhering to the international trade obligations of the United States is not listed in this section. One objective that is listed is 'promoting local hiring', which is described as follows:

"Departments and agencies should seek to maximise the economic benefits of a Recovery Act-funded investment in a particular community by supporting projects that seek to ensure that the people who live in the local community get the job opportunities that accompany the investment" (, 5).

It is noteworthy that the focus here is local and not national job creation. Furthermore, the next section of this document refers to 'additional responsibilities'

of Executive Branch agencies. Here specific mention is made of Section 1605 of the ARRA and the following selective quotation from that section is given:

"…[n]one of the funds appropriated or otherwise made available by this 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 United States". (, 6)

While it is acknowledged that exceptions to the ban exist, they are not specified. Nor is any mention made of Section 1605(d), whose inclusion did so much to placate international criticism at the time of the enactment of the ARRA legislation.

The Federal Acquisition Regulation has also been amended, on an interim basis, to take account of Section 1605 of the ARRA. The amendment was published in the US Federal Register on 31 March 2009 and specifically relates to 'construction materials'. With the publication of the interim rule came a request for comments from third parties. The deadline for receipt of comments does not suggest that the final rule will be issued before 1 June 2009, implying that the rules governing the implementation of the Buy American section of the ARRA could be tightened further.

The Interim Rule begins by summarising in neutral terms the content of Section 1605. In the ensuing discussion of this section, a number of points are made. First, while the three exceptions to Section 1605 are similar to those in the original *Buy American Act*, the ARRA requires the publication of a detailed written justification if a federal agency wishes to invoke any of these exceptions. Second, unlike the *Buy American Act*, the ARRA does not specify that a certain proportion of the components of domestic manufactured construction material be US-made too. Consequently, the Interim Rule's definition of domestic manufactured construction material omits any reference to such a sourcing rule. Third, it is acknowledged that unmanufactured construction material is not specifically mentioned in Section 1605 of the ARRA. Yet the authors of the Interim Rule make their position clear but stating immediately thereafter:

"However, the Recovery Act's purpose of creating jobs and stimulating domestic demand is well served by applying the Buy American Act to unmanufactured construction material".[6]

With respect to the use of materials from trading partners mentioned in the Conference Report described above, the Interim Rule confirms their treatment comparable to domestic contractors. However, the Interim Rule goes on to note that some US trading partners that have received forms of preferential market access in other areas will receive such treatment under this Rule:

[6] Indeed, in the proposed text for 'Subpart 25.6' 'Policy 25.602' it is proposed to treat unmanufactured construction material in the same way as it is under the *Buy American Act*. This is an example of the discretion being used by Federal authorities in a manner that arguably restricts international commerce.

"In the Recovery Act conference report, Congress expressed its intent that least developed countries be excepted from section 1605 and that they retain their status as designated countries. However, with respect to Caribbean Basin countries, Congress did not express a similar intent. Therefore, Caribbean Basin countries are not included as designated countries with respect to the Recovery Act".[7]

Next, a procedure was established whereby a contractor or potential contractor could request permission to use foreign construction material. In addition to providing information about the material sought, a 'detailed justification' of the reasons for using the material must be provided. Finally, penalties for failing to comply with these regulations were articulated, including defaulting the contract, debarment, and where fraud is suspected for potential criminal investigation.

The ARRA also provided funds for the US states to undertake investments in clean water and drinking water. This scheme is to be implemented at the Federal level by the EPA and on 28 April 2009 it issued regulations concerning assistance received under the Clean Water State Revolving Loan Fund and the Drinking Water State Revolving Fund. (The ARRA authorised $4 billion and $2 billion for these two funds, respectively.) In its implementing guidance, having stated its 'foremost expectation' is that recipients of these funds use American iron, steel, and manufactured goods, the EPA does mention the available exceptions and allowing purchases from GPA signatories, free trade agreement partners of the US, and least developed countries.

The EPA also proposed a procedure whereby a waiver from the Section 1605 restrictions can be obtained. Considerable amounts of information must be provided by a party seeking a waiver, as was the case with the Interim Rule. In addition, the EPA issued an extensive worksheet through which officials can evaluate waiver requests. It should be noted that these requirements must be met by all firms seeking a waiver, irrespective of nationality. Whether it is easier for US firms to assemble the information necessary to meet the standards of a waiver remains to be seen.

The EPA further proposes that a clause relating to Section 1605 requirements be added to each contract signed for an ARRA-funded project. The EPA is recommending that each contractor attests to (a) reviewing and understanding the Buy American requirements in the ARRA, (b) that all of the iron, steel, or manufactured goods used in the contract have or will come from the United States, have been produced in the United States according to Buy American standards, or a waiver was obtained, and (c) that the contractor will provide any "verified information, certification, or assurance of compliance" with this clause. A similar detailed text is suggested for bidders for the funds under these two water-related schemes. As will become clear below, there is already evidence from firms that these statements have been used to discourage bidding by foreign firms for these ARRA-funded projects.

[7] Specific text in the implementing text for the Interim Rule is proposed to this effect.

It is important to appreciate that the above guidance from the EPA is directed towards non-Federal government officials and those firms seeking to supply goods to an ARRA-funded project, even if it is implemented by a state or city government.

Overall, the US Federal agencies tasked with implementing the procurement rules for the ARRA Act have, with few exceptions, employed their discretion in a way that adds to the burdens of those firms seeking waivers. Those firms, in the United States and elsewhere, that have outsourced abroad the purchase of covered products, are presented with a strong incentive to source from home, unless the firm in question believes the cost of providing the information necessary to get a waiver is small.

One might view the ARRA and its implementing text as an aberration. However, recently the US House of Representatives passed the *Water Quality Improvement Act* which did not explicitly mention Buy American requirements; instead it included the following section:

SEC. 608. REQUIREMENTS FOR USE OF AMERICAN MATERIALS.

(a) In General—Notwithstanding any other provision of law, none of the funds made available by a State water pollution control revolving fund as authorised under this title may be used for the construction of treatment works unless the steel, iron, and manufactured goods used in such treatment works are produced in the United States.

(b) Exceptions: Subsection (a) shall not apply in any case in which the Administrator (in consultation with the Governor of the State) finds that:
  (1) applying subsection (a) would be inconsistent with the public interest;
  (2) steel, iron, and manufactured goods are not produced in the United States in sufficient and reasonably available quantities and of a satisfactory quality; or
  (3) inclusion of steel, iron, and manufactured goods produced in the United States will increase the cost of the overall project by more than 25 percent.

(c) Public Notification and Written Justification for Waiver—If the Administrator determines that it is necessary to waive the application of subsection (a) based on a finding under subsection (b), the Administrator shall:
  (1) not less than 15 days prior to waiving application of subsection (a), provide public notice and the opportunity to comment on the Administrator's intent to issue such waiver; and
  (2) upon issuing such waiver, publish in the Federal Register a detailed written justification as to why the provision is being waived.

(d) Consistency With International Agreements—This section shall be applied in a manner consistent with United States' obligations under international agreements.

This piece of legislation seeks to appropriate over $15 billion over five years for investment projects in improving water quality.[8] The passage of this bill by the House after the ARRA suggests that Buy American provisions need not carry that label.[9] By contrast, the *Omnibus Appropriations Act, 2009* reverts to citing the pre-ARRA Buy American legislation.

Given that the US stimulus package was only enacted 150 days ago, quantitative and representative evidence of its effects is thin on the ground. Evidence is growing across the Canadian border, however, that suggests that some of the implementing regulations for the Section 1605 Buy American requirements are beginning to bite. Recently, one newspaper reported:

> "...other Canadian companies doing business with state and local governments in the US report being forced to sign affidavits that all their materials were made in the U.S., or they will not be allowed to do business there".[10]

The *Toronto Star* newspaper recently referred to a "plague of protectionist measures in the US".

It has also been reported that one Swiss-Russian steel firm, Duferco Farrell Corporation, has introduced 'rolling layoffs' for 80 percent of its 600-person workforce in Pittsburgh because its established global supply chain cannot be reconciled with the tougher Buy American requirements. Its largest client cancelled orders and is now buying from companies where all of their production meets the new procurement regulations.[11]

Another case involves a Canadian firm, Hayward Gordon, which manufactures pumps used in water works projects. The President of this company claims he has been told by several towns, including Peru, Indiana, that they can no longer buy Canadian-made products. In another example the company was unable to bid for a contract in Maryland worth $200,000 because a bid document asked the company to 'provide a list of all iron, steel, and manufactured goods 'not' produced in the United States to be precluded from the funding".[12] Because of inci-

[8] The Canadian Manufacturers and Exporters Association contends that 250 of its members are threatened by this legislation. See "Town retaliating against US protectionism", *The Canadian Press*. 13 May 2009.

[9] Subsequently more examples of Congress legislating the newer, tougher Buy American legislation have become known. The *Global Trade Alert* attempts to monitor, amongst other trade-affecting state initiatives, 'buy local' procurement measures. Readers can review the measures reported for the United States at the following webpage, http://www.globaltradealert.org/measure?page=2&tid=All&tid_1=494&tid_3=All. A number of those reported measures refer to post-ARRA legislation containing Buy America provisions.

[10] "Stimulating Trade Wars", *Investor's Business Daily*, 18 May 2009.

[11] "Trade Wars Launched With Ruses, End Runs; Outrage in Canada as US Firms Sever Ties To Obey Stimulus Rules", *Washington Post*, 15 May 2009. Readers may want to note that earlier newspaper accounts asserted that Duferco Farrell Corporation had actually laid off workers. Subsequent corrections noted this company had introduced 'rolling layoffs'; alas the distinction between the two states was not made clear.

[12] "Protectionist measures delay recovery; A key lesson from the Great Depression is that protectionism makes everyone worse off", *The Toronto Star*, 26 March 2009. For further details see "Canadian firm cries foul over Buy American provision on state contract", *The Canadian Press*, 10 March 2009. In the latter article the chief executive of the company concerned is quoted as saying "We just spent $7 million on a brand new factory two years ago that's going to be gutted as a result of this".

dents such as these, Hayward Gordon is considering moving some manufacturing operations to the United States. More generally, it has been argued that:

"Canadian firms have been surprised to discover that while some contracts are still open to Canadian materials and equipment because of trade treaties, most of those issues issued by state and local governments are not." [13]

Moving production to the United States may not be enough for Canadian firms to regain sales. A group of US sewage makers wrote to members of the US House of Representatives in early March to warn that impending legislation could provoke retaliation by trading partners and "...immobilize our markets by undermining our member companies' ability to produce in their normal supply chain".[14] Such considerations suggest that the discrimination in the latest Buy American regulations is actually between US firms that have never outsourced and every other firm.

Added to the strict implementing regulations is the magnitude of the transfers from the Federal Government to the state and city governments.[15] Earlier in the year a paper by two prominent economists in the US administration estimated that 60 percent of Federal transfers to the states would be spent on goods and services (Romer and Bernstein 2009). The Government Accountability Office estimates that $280 billion of the stimulus package will be administered by the states; an independent estimate of the size of the transfers to the states is $214 billion, almost all of which will be spent by 2011 (Cogak et al. 2009). This implies that $120–150 billion of spending power in the hands of officials that may not feel minded to follow international trade obligations as much as the US Federal government.

Another factor to be taken into account is that many sub-federal procurement bodies in the United States appear to have adopted Buy American resolutions or provisions of their own. The United Steel Workers union is encouraging state and city governments to pass 'Make Our Future Work' resolutions that include Buy American provisions. The union's website boasts that over 500 states and cities have passed such resolutions. Careful examination of the site[16], however, reveals that 483 resolutions have been passed, including by the legislatures of several

[13] "Trade Wars Launched With Ruses, End Runs; Outrage in Canada as US Firms Sever Ties To Obey Stimulus Rules", *Washington Post*, 15 May 2009. In another news article, the Canadian Trade Minister, Mr Stockwell Day, is reported to have said that Congressional measures have discouraged municipal and state governments from buying from foreign companies. See "Ottawa warns US of possible retaliation; Trade Minister fears rising tide of protectionism", *Montreal Gazette*, 29 April 2008.

[14] "Despite assurances, Buy American lives; language restricting foreign supplies showing up in a variety of state and local spending bills; Canadian companies in a 'panic'" *The Globe and Mail*, 11 March 2009.

[15] It should be noted that the United States Federal Government is not alone in transferring significant amounts of money to sub-national governments as part of a stimulus package. The Canadian Federal Government has done likewise with the infrastructure component of its stimulus package (in this case with respect to the provinces.)

[16] The website in question, http://www.usw.org/media_center/news_articles?id=0238, was checked on 14 July 2009 and the numbers in the text refer to this date. Readers may be interested in knowing that the same website was checked on 25 May 2009 when 341 resolutions had been passed by sub-federal governments and another 766 resolutions were 'being pursued' according to the union.

large states. A further 542 resolutions are 'being pursued' and 33 such resolutions 'failed' according to the union. While it would be desirable to verify such data before accepting it at face value, the scale of the campaign does suggest any subfederal 'toughness' in implementing Buy American provisions is not solely due to Federal guidance.

3. THE REACTION OF THE TRADING PARTNERS

The loss of contracts in the United States has not gone unnoticed in Canada and elsewhere.[17] It appears that business and political leaders are no longer satisfied that their country's status as a US free trade agreement partner is enough. Indeed, the head of the Canadian Manufacturers and Exporters Association recently warned of the growing pressure to retaliate against US exports. He argued:

"My members are saying 'I'm being locked out of the American market but Americans have unfettered access to Canadian Procurement'. There are growing pressures to have Canadian municipalities impose some reciprocal measures".[18]

Canadian diplomats in the United States have mounted a campaign to have the Buy American provisions revised. Canada's Ambassador to the United States is on record as arguing:

"Restrictive procurement practices, like Buy American, increase costs, complexity, and project timing, slowing down infrastructure spending when it is needed the most...U.S. restrictions on Canadian exports kill American jobs for US suppliers to Canadian companies and retaliatory actions will close markets for Canadian and US exporters around the world".[19]

Similar warnings were made to the US Chamber of Commerce by the Canadian Federal Trade Minister at the end of April 2009. In the interim, 12 towns and counties in the province of Ontario, with a population of half-a-million people, have introduced some form of retaliatory or Buy Canadian provision. On 7 June 2009, at the annual meeting of the Federation of Canadian Municipalities, Canada's mayors voted by a narrow margin to introduce discrimination against

[17] For example, in a speech in Chicago on 9 June 2009, the UK Ambassador to the United States, Mr Neil Sheinwald, criticised the implementation of the ARRA. Mr Sheinwald is reported to have said "However, the danger is that some officials interpret the 'buy- American' provisions as simply banning all foreign companies or foreign-made goods" (see "Embassy Row", *Washington Times*, 10 June 2009.) Singapore and Japan are said to have joined Canada and the United Kingdom in criticising the implementation of the ARRA, see "'Buy American' plan leads to ire, confusion", *Agence France Presse*, 6 June 2009. A file of newspaper clippings of recent US and Canadian reaction to the Buy American provisions is available from the author upon request.

[18] "US stimulus stifling Canada; Buy America rule boils down to protectionism", *National Post*, 30 April 2009.

[19] "Jobs at Risk due to Buy America Restrictions", *States News Service*, 7 June 2009. The same article also points out the extent of Canadian purchases from US companies:

"Canada buys almost four times more than China does from the US. In fact, Canada buys more from the United States. than the United Kingdom, Germany, Japan, and China combined. Trade with Canada supports about 7 million US jobs".

bidders for Canadian municipal contracts from countries that themselves discriminate against Canadian firms in public procurement if the latter favouritism is not removed within 120 days. It should be noted that this motion is not binding on Canadian municipalities, which, according to estimates, spend approximately C$15 billion on infrastructure projects in 2008.[20]

Finally, US companies have begun to complain about the implications of the Buy American provisions in the ARRA. For export-oriented firms the threat of retaliation by other countries is a concern. General Electric, Boeing Co., and Caterpillar have been identified as opposing these provisions. Indeed, the Director for Government Affairs of Caterpillar is quoted as saying:

> "The ability to sell globally is absolutely critical to our success...The US 'Buy American' package is fostering 'Buy Canadian' status or laws that would directly hurt American exports. With Caterpillar's largest US export market being Canada it's something that concerns us greatly".[21]

For US firms attempting to compete for ARRA-funded projects another concern has arisen, namely, confusion over the content and interpretation of the Buy American rules. The President of the Water and Wastewater Equipment Manufacturers Association, Dawn Champney, has been quoted as saying:

> "It is causing utter frustration for US companies...The Buy American clause has just put the market at a halt while these rules are being implemented, guidance is being issued and people are trying to make legal sense of it".[22]

Similarly, the Chief Executive Officer of Atlanta-based Mueller Water Products, a manufacturer of water and waste water treatment products, is reported to have said "Municipal spending has been paralyzed...primarily due to confusion over certain provisions, especially the Buy American clause".[23]

With this information on the implementation of the ARRA and the reaction of the private sector, on both sides of the US-Canadian border, attention now turns to the implications for trade policymaking.

4. CONCLUSIONS AND IMPLICATIONS FOR TRADE POLICYMAKING

Making specific reference to the implementation of one of the largest fiscal stimulus packages undertaken during the current global economic downturn, the purpose of this paper has been to identify the factors that are likely to affect the

[20] "Canadian cities fire back at Buy American policy; US bidders may be shut out from municipal tendering processes under agreement reached at weekend meeting in Whistler", Vancouver Sun, 8 June 2009.

[21] "'Buy America' trade limits cause Canadian businesses to look south, companies say", The Canadian Press, 10 June 2009.

[22] "Buy American under fire from US firms", Canwest News Service, 9 June 2009.

[23] The delays that appear to have been created by the Buy American provisions must surely compromise the Obama Administration's stated goal of funding 'shovel ready' (that is, quick to implement) projects that will speed-up the recovery of the United States economy.

impact of such packages on the world trading system. While the impact on cross-border trade and investment is naturally of interest, trade policymakers and analysts may also be keen to learn what the implications are for designing procurement provisions for inclusion in international trade accords.

To highlight what is at stake a detailed analysis of the implementation of the United States' American Recovery and Reinvestment Act, which was signed into law on 17 February 2009, was undertaken. While the total value of this package was US $787 billion, a fraction will be spent on public procurement (some have estimated that approximately a third of a trillion US dollars will be spent on goods and services). Readers may recall that the enactment of this stimulus package was very controversial both inside and outside the United States. Many trading partners expressed concerns about the so-called Buy American provisions in the proposed legislation, in particular the expansion of the products that must be sourced nationally to include 'manufacturing goods' (a very broad category). The focus of this paper, however, is not on that trading partners' criticism or the US Administration's immediate response, but on the subsequent implementation of the Act.

Even so, readers are cautioned that it is premature to come to any conclusions concerning the overall impact of recent stimulus packages. The package being implemented in the United States, for example, was enacted around 150 days ago and is expected to influence government spending over at least the next three years. It is too soon to make sweeping statements about the overall impact of these stimulus packages. The implications of this argument cut both ways. Those who fear that such stimulus packages will distort international commerce need to recognise that the regulations implementing the US stimulus package could be revised, possibly taking account of trading partners' concerns. Those who believe that this global downturn has not resulted in widespread protectionism should bear in mind both the scale of several nations' stimulus packages and the fact that to date only a small fraction of the monies appropriated have been spent.

A key finding of this paper is that the assurance offered to the US trading partners at the time of enactment, namely to implement the stimulus package in line with the US international trade commitments, has by and large not found its way into the implementing guidance given by Federal agencies to those spending the funds. Indeed, one Federal agency has suggested that US cities and states seek assurances from each firm that bids for stimulus package-funded projects that 100 percent of all their parts, components, and manufactured goods are US-made. Little or no mention is made of the fact that waivers can be sought for supplies from the least developed countries, the countries the United States has free trade agreements with, or the members of the World Trade Organization's Agreement on Government Procurement.

A detailed examination of the implementation of the US *American Recovery and Reinvestment Act* points to several implications for trade policymaking. This examination identified factors that may be relevant when evaluating other nations' stimulus packages; if so the following observations may be of more gen-

eral interest. The first implication of US experience is that it highlights the incomplete nature of the current set of international trade disciplines on public procurement matters. Arguably recent US experience demonstrates the folly of confining trade obligations to the expenditures of a government body and not to the transfers from that body to another body which is ultimately responsible for buying goods and services. The present arrangements merely encourage those seeking to prevent stimulus package monies being spent on foreign items to transfer funds from the central government to a government level or state body less constrained or unconstrained by international trade accords.

Second, given the widespread apparent adoption of Buy American resolutions by sub-federal authorities, there is a strong case for expanding trade disciplines against discrimination to them and making this a priority for future trade negotiations. For sure, certain sub-federal authorities in the United States. and elsewhere may resist such obligations. If a trading partner is unwilling to take on such additional obligations, then recent experience suggests that any public procurement-related commitments concerning the central government of that trading partner probably need to be discounted. Considerable thought is needed to examine how the discretion of those agencies responsible for setting procurement rules can be curbed so that any enacted mandates dictating non-discrimination against foreign bidders, even if qualified, is given the profile intended.

A third implication is that 'buy national' policies tend to spur retaliation by trading partners. Already several Canadian townships and cities are taking action to discourage purchases of US products. A sub-national government in Australia has just introduced a 'Local Jobs First' program. Perhaps, more significantly, at the beginning of June 2009 the Chinese government is said to have issued new 'buy national' regulations to its cities, provinces, and central government departments, although whether this represents a major change in policy is contested by Beijing.

Fourth, the fact that the implementing regulations for stimulus packages can change over time suggests that eternal vigilance on the part of trading partners is needed. Merely seeking assurances at the time of enactment from trading partners that their stimulus packages will respect international obligations looks, in retrospect, naive. Fifth, by excluding developing countries (but not the least developed countries) from potential preferential treatment in implementing Buy American provisions in its stimulus package, the United States has strengthened the incentive of developing countries to request the launch of negotiations towards a free trade agreement. Thus one form of discrimination (procurement discrimination) may beget another form of discrimination (tariff preferences).

Sixth, steps should be taken to limit the informational burdens necessary to obtain waivers from Buy American legislation and their counterparts in other jurisdictions. Given that outsourcing and international supply chains are pervasive, perhaps a model waiver could be developed. Finally, legislative provisions demanding that all iron, steel, and manufactured goods be produced in the United States effectively discriminates between those firms, both US and foreign, that

participate in international supply chains and those that do not. Thus the current implementing regulations for the US stimulus package seeks to discourage one of the modern innovations in international corporate practice, effectively promoting the entire repatriation of associated production to the United States.

The Buy American provisions in the US stimulus package, which themselves have been repackaged in other legislation that is currently working its way through the US Congress, could therefore have far-reaching implications for corporate strategy, international investment flows, as well as trade flows. The contrast between this outcome and the apparently innocuous language included in the *American Recovery and Reinvestment Act* emphasises the important fact that when it comes to recent procurement discrimination the devil is in the details and that another form of murky protectionism has been spawned.

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10

Exchange Rates During the Crisis

SEBASTIAN WEBER AND CHARLES WYPLOSZ[1]

1. INTRODUCTION

A key leitmotiv as we go through the crisis is to avoid a repeat of the policy mistakes of the Great Depression. There is general agreement that beggar-thy-neighbour competitive devaluations have been one key mistake, for it led to rising protectionism and a deconstruction of international trade (Kindleberger, 1973). Preventing this mistake from repeating was a central motivation at the Bretton Woods conference.

Although, there are already signs of increased trade protectionism (Gamberoni and Newfarmer, 2009), today's situation is very different from the 1930s. In the 1930s exchange rates were mostly fixed within the prevalent gold standard. Depreciations were the result of explicit decisions. Today, only some 42 percent of countries are officially pegging their exchange rates, although *de facto* pegging is detected in 45 percent.[2] This means that exchange rate movements do not necessarily reflect official decisions but rather are market-driven fluctuations.

Governments today have nominally many more policy tools at hand ranging from fiscal policy over labour markets to monetary policy measures. This should make them less reliant on measures which are perceived as beggar-thy-neighbour. However, nearly two years after the onset of the financial crisis, central banks around the world have brought their policy interest rates down to, or close to zero. Most countries have seen their budget deficits soar, reflecting both the automatic stabilisers and various degrees of discretionary actions.

While the recession is still under way, traditional instruments become severely constrained. In such a situation, it is natural that national authorities explore non-conventional policies. Central banks are experimenting with quantitative easing and credit easing. There is no guarantee that either type of non-conventional monetary policy will be successful; the Japanese precedent is not particularly encouraging either. Another non-conventional form of monetary policy is deliberately weakening of the exchange rate. This raises the spectre of the much-

[1] The authors like to thank the Swiss National Science Foundation for highly appreciated funding.

[2] The *de facto* number is based on the updated Reinhart and Rogoff classification (2004). An updated defacto classification by Ghosh (2003) puts this number somewhat higher with close to 50 percent.

feared beggar-thy-neighbour policies. Exchange rates have moved a lot since the onset of the crisis, but these movements have been mostly interpreted as by-products of expansionary policies. Sharp depreciations in countries like the United Kingdom or South Korea have not been welcome by the authorities, at least officially. Intentions, of course, are hard to detect and no one suggests that monetary policies should not be expansionary.

This paper examines the many questions that surround explicit or implicit exchange rate policies as the crisis continues. We start by discussing briefly the desirable evolution of exchange rates from a global perspective and the exchange rate consequences of traditional measures. Section 3 contrasts this global perspective with the incentives that operate on the level of the individual countries. We offer a measure of incentives to derive which countries have a particular interest in a relatively lower value of their own currency. In Section 4, we examine to what extent the deliberate, or merely market-driven occurrence of depreciations by a single country can lead to counter-depreciations initiating a contagious process that characterised the 1930s. We examine two possibilities. The first one involves competitive depreciations among the 46 large, systemically important countries. The alternative is competitive depreciations starting among smaller, non-systemically important countries spreading to more and more countries until it engulfs the whole world. Section 5 brings together the previous results to examine and evaluate possible actions that would remove the exchange rate from becoming an aggravating factor as the world hopefully comes to grip with the recession. Obviously, there is no miracle solution but a number of measures may mitigate the risks.

2. DESIRABLE EXCHANGE RATE POLICIES

Since the onset of the crisis exchange rates have moved sharply. As Figure 10.1 shows, the average *absolute* monthly change in the exchange rate relative to the US dollar for a sample of major export countries has increased sharply indicating a higher volatility in exchange rate markets.[3] Moreover the average change for the countries amounted to an 8 percent depreciation at its peak in 2008.[4]

A significant literature (for example, Roubini and Stetser, 2004; Obstfeld and Rogoff, 2005; Blanchard et al., 2005) has long argued that global imbalances – the combination of a large US current account deficit with Asian surpluses – were unsustainable and would result, sooner or later, into large exchange rate realignments, with potentially dramatic effects. Now that the crisis has happened, this view argues for monitoring exchange rates to make sure that they move in

[3] We concentrate on the 46 most important export countries, measured in exports in percentages of world exports. Results are unaffected when considering a broader set of countries.

[4] Note that when the two values are identical, all countries in the sample appreciated (or remained unchanged) against the United States in the respective year. This is two times the case: in M11 2004 and right after the outbreak of the crisis in M10 2007. In our sample it is never the case that all countries depreciate against the US dollar in a given month.

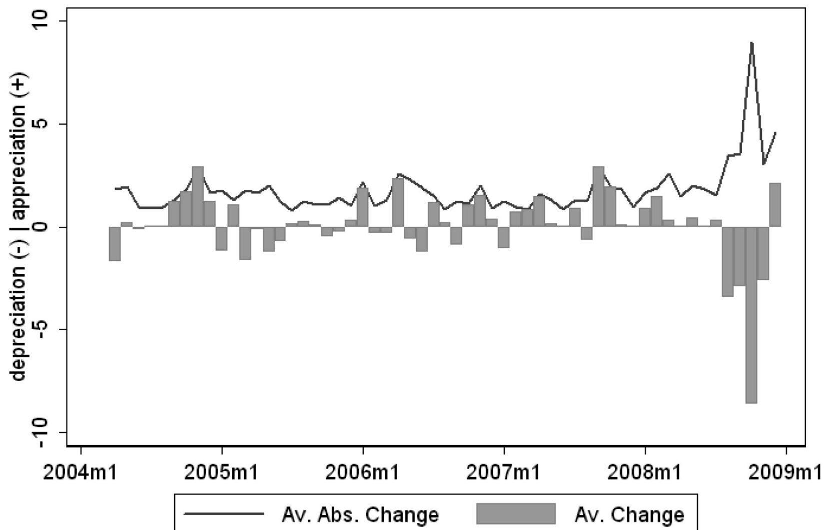

Figure 10.1: *Exchange Rate Developments*

Source: IFS and authors' own calculation.

the right direction. This leads to reasonably simple conclusions. In particular the US dollar needs to depreciate to eliminate the current account deficit and the Asian currencies, chiefly the Chinese renminbi, must appreciate to reduce their surpluses. Ominously, the dollar has appreciated and several Asian currencies – but not the renminbi – have nearly crashed.

However, the crisis has happened largely for other reasons. Indeed, another literature initially claimed that the imbalances could be sustained long enough not to call for massive realignments (Dooley et al., 2003; Caballero et al., 2006). This alternative literature holds that the global imbalances are not a cause of the crisis, but a symptom of other disequilibria originating in the financial markets in the United States and elsewhere (Dooley et al., 2009; Caballero et al., 2009). In that view the exchange rates cannot play centre stage in resolving the underlying disequilibria. Their desirable evolution must be based on other criteria.

Whichever literature holds true, there is a case for a desirable evolution of exchange rates, from a world welfare viewpoint, which facilitates the international adjustment to shocks and disequilibria. But given that the sources of the disequilibria are not generally agreed upon, pinpointing the solution for the required path is far too complex a task making a coordinated response close to impossible. Under this uncertainty, using explicitly the exchange rate should be a last-resort option, since it can be helpful only if few countries adopt it and is at the cost of other nations' competitiveness. It follows that other options must be implemented first.

2.1 traditional monetary policy option

Obviously, the first instrument is monetary policy. However, an easier monetary policy through interest rate cuts is also expected to be accompanied by an exchange rate depreciation. In fact, the depreciation is the main channel of monetary policy in small open economies. This implies that a fully coordinated monetary expansion would translate into exchange rate changes only to the extent that their magnitude differs from one country to another. It follows that monetary policies will have to be primarily on other channels. All these channels involve the banking and financial systems. In most developed countries, these systems are impaired and demand for credit is highly subdued. This is why we observe a massive accumulation of liquidity in banks with little credit expansion. In developing countries, financial systems are small and unlikely to transmit the expansion.

Thus monetary policy is likely to work mostly in a small number of developed and emerging-market countries that have sufficiently robust banking systems. If this conclusion is warranted, it follows that the other countries will benefit from the monetary policy instrument to the extent that they depreciate relative to the countries that can rely on the domestic banking channel.

2.2 The fiscal policy option

The second conventional instrument is fiscal policy. It is a complex instrument whose effects are surprisingly little known, in spite of decades of theoretical and empirical research.[5] However, there is a compelling case that fiscal policy is hampered in very open economies, as a significant part of any boost is bound to leak abroad in the form of imports. This risk is magnified in countries where the exchange rate freely floats if a fiscal expansion triggers an appreciation.[6] Despite these misgivings, it is the only conventional macroeconomic instrument left and it should be used wherever governments can borrow substantial amounts.

The optimal world distribution of fiscal policy effort should recognise the room for manoeuvre (pre-existing debt, ability to borrow, administrative capacity). While we know far too little about the impact of fiscal policies on exchange rate changes, the safe conclusion is that exchange rates should be stabilised. Put differently, if we are going to rely mostly on fiscal policies, hopefully coordinated, the exchange rate should be a playing field as neutral as is possible. Countries that can undertake such policies, with positive externalities for those that cannot, should be protected from potentially offsetting appreciations likely to deter policy action in the first place.

[5] As recently observed by Yung Chul Park, the IMF's *World Economic Outlook* concludes in its October 2008 issue that fiscal policy is largely ineffective, while it finds it effective in its April 2009 version.

[6] The Mundell-Fleming model predicts a 100 percent offset that makes fiscal policy wholly ineffective.

3. COUNTRY-LEVEL INCENTIVES

With policy rates approaching the zero lower bound and budget deficits soaring, policy options become severely constrained. Additionally, policies like fiscal expansion have to be paid at a national level, while their benefits can dilute away to other nations, which makes more direct measures attractive. Many developed and emerging markets have been hit hard by dropping export revenues as a result of the global contraction and falling prices for major export products. To ease the domestic adjustment burden, several countries have an incentive to manage their exchange rate in such a manner that their economies remain competitive. This appears to come at no cost and promises to have a direct impact. However, such a step puts other nations at a disadvantage and imposes on them a disproportionally higher adjustment burden. The consequence is that the behaviour of few countries could be contagious.

The likelihood of engaging in exchange rate depreciation policies can be seen as a function of the associated cost and benefits, the range of alternative options to choose from, and the political will to engage in actions perceived as beggar-thy-neighbour. The benefits should be increasing in both the importance of the external trade balance for total output, and the elasticity of the trade balance to exchange rate changes. The costs are increasing in the level of foreign currency indebtedness and the threat of rising inflation.

The alternative options that are available will also play a key role in defining whether policy makers will embark on direct exchange rate intervention or not. Within the group of the major export nations, some countries are already heavily constrained in the extent to which they can choose from various macroeconomic policy options. Countries which: (1) are close to the zero lower bound interest rate lose the classical monetary policy channel; (2) have a very high public debt ratio, and may not want to increase future debt burdens even more, making fiscal expansion less likely; and (3) expect that low inflation rates are more likely to increase the monetary mass, since the output concerns tend to outweigh the inflation concerns, and deflation worries may even make depreciations more likely.

The political willingness to engage in a devaluation may be captured to some extent by the past experience of exchange rate misalignment. Finally, there must be a strong enough incentive to engage in expansionary policies in the first place, which may be captured by the expected growth slowdown.

3.1 Evaluation of incentives

The outlook matters a lot as authorities evaluate their options. Since the onset of the crisis, economic forecasting has proven to be extremely difficult, if not impossible. Output and inflation forecasts have constantly been revised, by large margins, within very short periods and always downward. This is normal, as the forecasting models either rely on econometric estimates from sample periods that do not include a crisis of the kind that is unfolding, or are based on theoretical

models that do not allow for any of the on-going events (bubbles, financial meltdown, or seizure of financial markets) and the policy responses so far. In Figure 10.2, we use forecasts provided by the Economist Intelligence Unit as an illustration of the issues at stake, while warning that these forecasts can prove to be as unreliable as the recent ones. For half the countries in our sample of exporters, output is predicted to contract by more than 5 percentage points. Only seven countries are expected to register a non-negative growth rate.

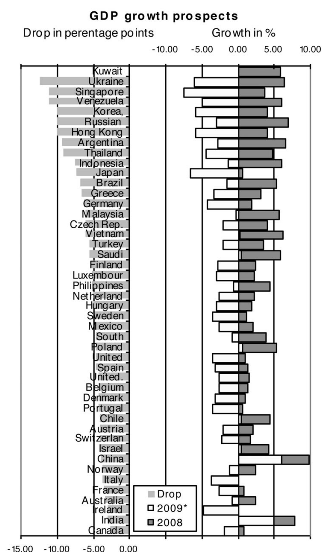

Figure 10.2: *GDP Growth*

Source: EIU (April 2009), no forecast is available for Kuwait

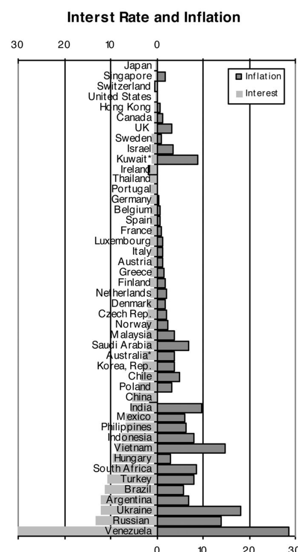

Figure 10.3: *Interest Rates and Inflation*

Source: Interest Rate is the policy rate as of April 2009 (Central Banks) and inflation is the latest figure from EIU (April 2009)

The largest drops in output growth are expected to occur in various Asian countries including Japan, Thailand, and Singapore as well as in Argentina and Venezuela.

3.2 *Interest rates and inflation*

Figure 10.3 shows that interest rates are close or below 1 percent in more than half of the countries of our sample. Only six of these countries have an inflation rate in excess of 1 percent, which means that many of the countries that have hit the lower bound still face positive real interest rates. The list of countries which are close to the zero lower bound includes most developed countries: the United States, Japan, the United Kingdom, Canada, Sweden, Switzerland, Singapore, and Hong Kong.

3.3. Deficits and Debts

Debt as a percent of GDP in our sample stands on average at 46 percent. Most prominently, in Japan and Singapore debt levels exceed 100 percent of GDP.[7] Both countries are expected to experience a severe output contraction in 2009 and have seen their competitiveness seriously eroded (Figure 10.7). European countries tend also to have a relatively high debt level, in particular Italy, Greece, and Belgium. Finally, some emerging markets including Hungary, Israel, and India belong to the group of high-debt countries. Given the recent worldwide fiscal expansion these figures will increase over the next year by several percentage points.

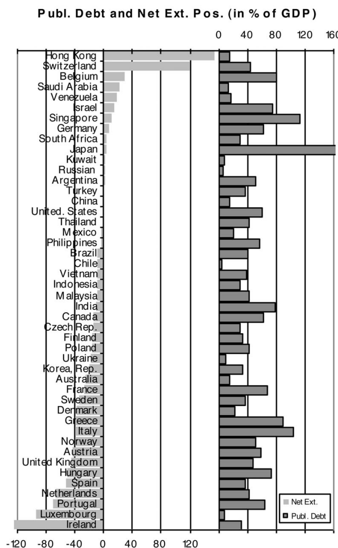

Figure 10.4: *Debt and Net Foreign Assets*

Source: BIS (2008 Q3) and CIA Factbook (2008)

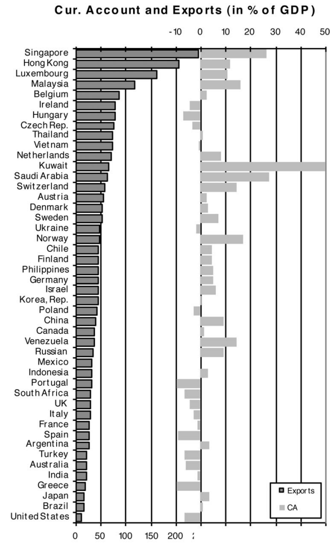

Figure 10.5: *Current Account Balance*

Source: WEO, pre-crisis levels (2006)

3.4. Current Account and External Positions

While there may be several countries that benefit from more competitive exchange rates, others do all they can to avoid a depreciation of their currency. Unsurprisingly, these are primarily countries in Central and Eastern Europe who have accumulated high foreign liabilities often due to the anticipated Euro accession and the favourable interest rate differentials. For these countries any depreciation increases the foreign currency debt and thereby threatens the stability of their financial sector. Hungary features in our sample with a relatively high net

[7] Despite this fact, Japan already decided to increase its deficits to new record levels.

foreign liability, as measured by the external position *vis-à-vis* BIS reporting banks relative to GDP (50 percent). The levels for Poland (15 percent) and the Czech Republic (13 percent) as well as Korea (19 percent) and the Ukraine (18 percent) appear to be less worrisome. The bulk of countries with high net external liabilities are the EU countries and Norway. On the other hand, countries with a positive net external position do not suffer any (aggregate) losses from exchange rate depreciations. This group includes highly integrated countries like Switzerland, Hong Kong, Singapore, and Belgium but also countries like Venezuela, Israel, and Saudi Arabia.

In terms of trade patterns, the four countries which have the highest export to GDP ratio (Singapore, Hong Kong, Luxemburg, Malaysia, and Belgium) used to maintain on average current account surpluses well above 10 percent.[8] Other countries with such high current account surpluses are the oil producers, Switzerland, and China. Interestingly, the countries for which exports appear to contribute less to GDP are also the countries with the highest current account deficits. In fact, in our sample there is a significant positive correlation between the pre-crisis current account surplus and the importance of exports in GDP measured in percentage of GDP. To the extent that exchange rate depreciation boosts exports, this implies that countries, which have more to gain from a percentage increase in exports, tend to have already a current account surplus.

3.5 Exchange rates: initial situation and recent changes

At the onset to the crisis various countries have been said to maintain undervalued exchange rates by not allowing their nominal exchange rate to depreciate, thereby contributing to the global imbalances. To measure this extent of misalignment we use a simple extended PPP approach to estimate the equilibrium rate along the lines of Cheung et al (2008). The approach chosen here is based on the consideration that the evolution of the real exchange rate is a function of (slow-moving) factors affecting the equilibrium exchange rate and factors, which in the short-run lead to a deviation from the equilibrium rate.[9] These deviations may be a result of country-specific policies such as the accumulation of foreign reserves. The misalignment may then be interpreted as the percentage deviation of the actual real exchange rate from the predicted rate, where the prediction is based on letting only the changes in the structural, slow-moving factors affect the real equilibrium rate, holding policy variables unchanged.

3.5.1 Initial situation

One of the findings of this analysis is that *de facto* floats – as theory predicts – do in fact equilibrate better than pegged regimes in the sense that we find less

[8] Using the trade balance rather than the current account would be no less impressive.

[9] For a more detailed description of the approach we chose in measuring exchange rate misalignment see Appendix A and B.

evidence of misalignment for these countries. Figure 10.6 indicates the point estimate as well as a country-specific confidence interval, based on two standard deviations of the country-specific errors.[10] Of the *de facto* floaters in our sample, with the exception of Turkey, that we find highly overvalued, Japan, South Africa, and Australia are not misaligned. On the other side, all major exporting countries that maintain a *de facto* peg are found to have been highly misaligned in 2007. This group is composed of China, Hong Kong, Saudi Arabia, Kuwait, the Ukraine, and Denmark. There is also evidence that countries with current account deficits tend to have overvalued currencies (including Poland, Czech Republic, Greece, Portugal, Spain, and Turkey). On the other hand, the undervalued-currency countries tend to have trade surpluses (China, Malaysia, Singapore, Indonesia, Saudi Arabia, Kuwait, and Chile). They have higher reserve coffers and are unlikely to switch quickly from export-driven to internal, consumer-driven growth.

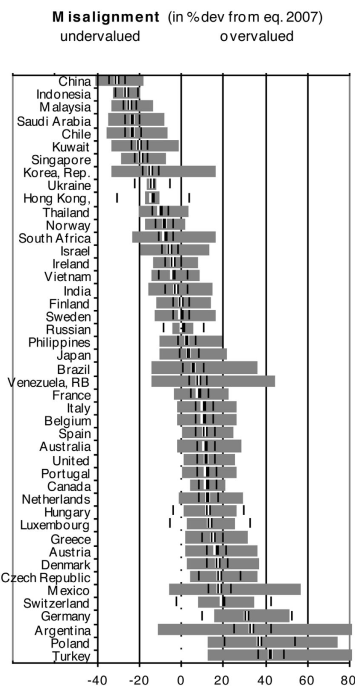

Figure 10.6: *Initial Misalignment*

Source: See Appendix A and B

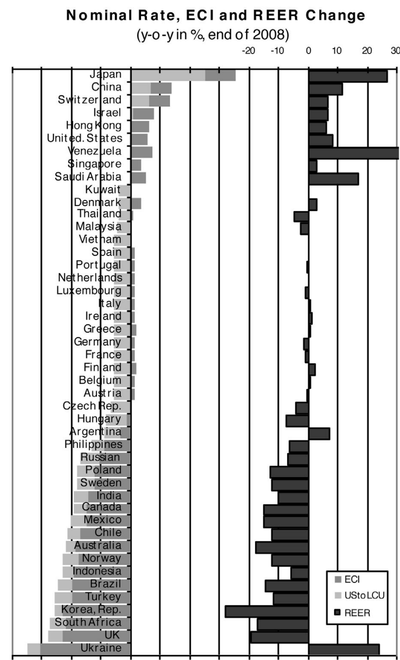

Figure 10.7: *Recent Exchange Rate Changes*

Source: BIS, IFS, and authors' calculation

[10] The parameter uncertainty is given by the black left and right lines to the mid-point estimate. Generally these tend to be very low.

3.5.2. Recent Changes

The recent changes in exchange rates have been mitigating the undervaluation in instances where nations pegged to the dollar and currencies moved nearly one-for-one (China, Singapore, Saudi Arabia). This appears to be true when measuring the adjustment in terms of the real exchange rate, the nominal rate with respect to the dollar, or in terms of the ECI, an index which captures the nominal third-market competitiveness of a country.[11] Surprisingly perhaps, the currencies that float more freely against the dollar have mostly depreciated in 2008, thus deepening the further undervaluation in certain cases. This concerns Chile, Indonesia, and to a lesser extent Malaysia. Euro-zone members that already appeared overvalued do seem to be on the losing end, since the Euro remains relatively stable, while neighbouring European countries, like Norway, Sweden, and the United Kingdom are benefiting from their depreciated rates. While these developments are to some extent in line with the adjustment of global imbalances, this is not entirely the case.[12] Both the US dollar and the Euro appear to be too strong, given the external position of the United States and most Euro-zone members.

3.6 Incentive index

We bring these various incentives together now by computing a single index based on the above observations. The index, which is designed to gauge incentives to depreciate, is computed as the simple average of the ranks of each country along the eight criteria. These are: the nominal interest rate, the inflation rate, the inverse of the export to GDP ratio, the pre-crisis extent of undervaluation, the inverse of the public debt level, the negative value of the net foreign asset position, the expected drop in output growth and the negative value of the change in the ECI.[13] Thus a lower (more negative) value implies a stronger incentive to depreciate, and is therefore associated with a higher rank. The index ranges from a minimum of 1, the highest possible incentive to depreciate, to 46.[14]

Clearly, this index should be interpreted with care. To start with, the criteria are equally weighted, which simply reflects the absence of strong priors. It may well be that different countries attach different importance to the criteria. In addition, the index does not account for other potentially important factors like the presence of a financial centre or heterogeneity within a country. One could also note that using rank order may underplay the differences among the countries' performances.

[11] The ECI is described in more detail in the next section.

[12] In particular the US dollar should be depreciating against most Asian currencies.

[13] We also explored other methods, for example ascribing values to the top 10 (quartile) and bottom 10 (quartile) countries for each criterion. The results for the upper and lower group are essentially unaffected.

[14] For Kuwait we had not enough data to compute the ECI and there was no growth prediction available. For the United States we have no measure of misalignment. The two countries' index value is therefore based on the remaining sub-indices.

Keeping those caveats in mind, it is worth noting that the group of countries with the highest incentive includes two countries, Switzerland and Singapore, which have already taken (limited) action to weaken their exchange rates. At the other end of the spectrum, we find the Ukraine, which has already seen its exchange rate depreciate by roughly 35 percent and is therefore unlikely to see further changes. That they are at the two extremes is explained by the fact that Ukraine's devaluation is already accounted for, while Singapore and Switzerland's devaluations are not registered in the exchange rate indicator, since they took place in April and March of 2009, respectively. Additionally, the extent of the devaluations in Switzerland and Singapore were rather low and do not preclude future devaluations, while this is considered unlikely for the Ukraine with relatively high inflation and negative net foreign assets.

It is interesting to note that China is found to have a rather high incentive to depreciate. China's exchange rate policy is a very sensitive issue though, which may explain why it has recently chosen to adopt a very expansionary fiscal policy. This might temporarily reduce global imbalances, but large surpluses could reappear once the fiscal boost comes to an end. This could rekindle demands that it appreciates. Given its large reserves however, China stands to suffer serious losses were it to let its currency appreciate against the dollar.

Meanwhile, China's stance on the exchange rate is exerting a powerful influence throughout East Asia. Some countries, for instance Korea, have experienced deep depreciations, which may paradoxically be raising China's competitiveness, since much of its export goods incorporate parts manufactured elsewhere in the region. But China's goods also enter the production chain of other East Asian countries, thus reducing the competitiveness gains from depreciation.

Other countries found to have a high incentive to devalue include Japan, Thailand, Israel, Malaysia, Saudi Arabia, the United States, and Germany, which is however constrained by the common monetary policy of the Euro area. From an economic perspective it may be highly tempting for Japan to devalue in the current situation, but the political cost is potentially much higher. However, in the case of Japan and the United States a further increase in the monetary mass, which may eventually lead to a depreciation, seems much more likely since it is not associated with the stigma of being beggar-thy-neighbour. Finally, it is worth noting that many emerging markets and Australia, which have recently been depreciating heavily, feature at the end of the list.

Brazil, Mexico, Argentina, and Chile had been depreciating heavily last year. While this development seems consistent with the external position of Mexico and Brazil, and their real exchange rates that have been above equilibrium levels (though insignificantly so), for Chile developments are contributing to an already competitive exchange rate. However, for none of these countries do we find a strong incentive to devalue, primarily since policy options are not (yet) constrained and competitiveness is already relatively high given the recent depreciations.

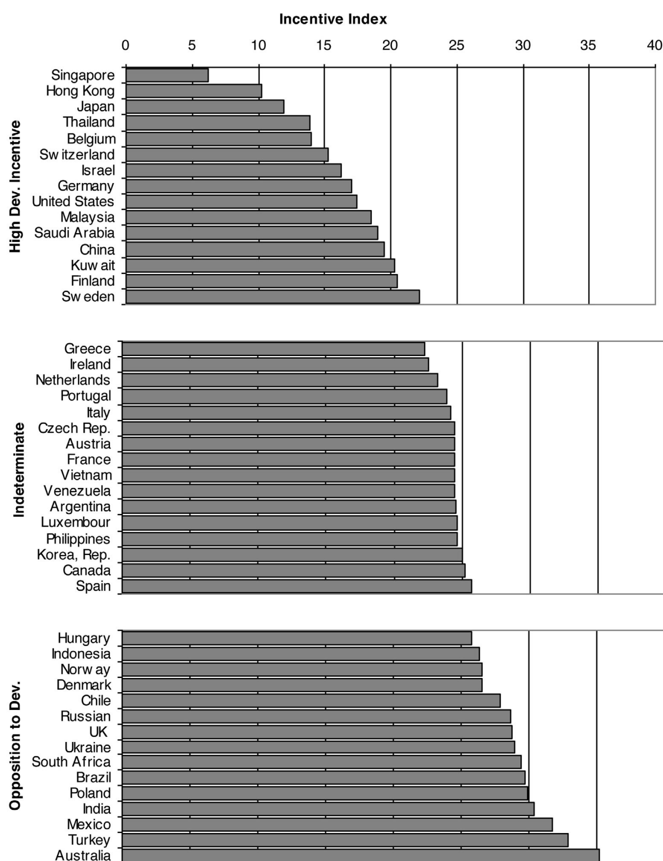

Figure 10.8: *Incentive Index*

Raw material exporters, which peg or maintain a band to the US dollar including Saudi Arabia and Kuwait, could devalue as already happened in Kazakhstan and Ukraine, two other raw material exporters. However, Saudi Arabia and Kuwait have a relatively high buffer of reserves and low debt burdens, which should induce them to rely more on a fiscal stimulus as opposed to monetary policy actions. Nevertheless, they may be tempted, since both countries have lost competitiveness in recent months by pegging to the US dollar and interest rates in both countries are already very low.

All in all, the incentive index provides a disquieting picture. Some of the most important world exporters, in particular Singapore, Hong Kong, China, Japan and the United States, are found to face powerful incentives to seek a weakening of their exchange rates.

4. CONTAGION

The rising incentives to maintain a competitive exchange rate have already led to the first explicit steps. Since the end of 2008, at least nine countries officially devalued their exchange rate, as shown in Table 10.1. Within the last year nearly all major export nations' currencies have weakened against the US dollar. However, it is very difficult to distinguish between explicit exchange rate decisions and the exchange rate implication of monetary policy actions if countries maintain a (managed) float. In some cases (Sweden and the United Kingdom), it is clear that this is the outcome of monetary policy actions. In other cases (Russia and several CIS countries), the authorities have tried to prevent or slow down the depreciations and have ended up attempting to control the process. A few countries (Vietnam, Singapore, and Switzerland) have taken explicit steps. In some cases, the instauration of capital controls shows that the depreciations were not welcome at all. Argentina, on the other hand, has lifted its controls

Are these developments a source of concern? Not as long as they remain limited because they are accepted as a consequence of the situation (like Iceland's massive depreciation), or of domestically oriented policies. As emphasised earlier, there exists a pattern of exchange rate changes that is justified. However, the movements in a situation of global output decline bear the risk that some large exporters feel threatened and respond. A second risk is that exchange rate decisions among small countries trigger a bottom-up reaction chain.

4.1 Contagion risks among major export countries

Devaluations by major export nations are likely to disrupt trade patterns. Recent movements of nominal exchange rates have already significantly shifted the competitiveness of countries. To shed some light on these changes we look at a measure of the effective exchange rate which we call ECI (External Competitiveness Index) designed to reflect third-market effects.[15] Rather than contrasting the relative competitiveness of exports to imports as a nominal effective exchange rate does, the index compares the competitiveness of the own exports relative to the exports of the competitors in third markets based on the changes in the nominal exchange rates with respect to the destination currency. This implies that one country's devaluation/depreciation worsens the competitors' situation, which is reflected in an increase in the ECI, even if the own exchange rate with respect to the destination market remained unchanged. A drastic increase in the ECI level can hence be seen as reflecting an increased risk of devaluation due to third-market effects, that is, contagion.

In general the variability of industrial countries' ECIs has been moderate. So have been the ECIs of countries that peg to the US dollar (China, Hong Kong, Saudi Arabia). However, towards the end of the period it becomes clear that Germany, Switzerland, and the United States have lost in competitiveness since other

[15] See Appendix C for details.

Table 10.1: *Foreign Exchange Market Outcomes (since end of 2008)*

Measures Taken Since End 2008 (Indicative, non exhaustive list)		
Exchange Rate		
Date	**Country**	**Measure**
Oct. 2008	Iceland	Failed attempt to introduce currency peg as capital flight lead to heavy deprecation
Dec. 2008	Angola	Devaluation (10%)
Dec. 2008	Ukraine	Devaluation (30%)
Jan. 2009	Belarus	Devaluation (20%)
Feb. 2009	Argentina	"Managed (gradual)" Depreciation
Feb. 2009	Russia	"Managed (gradual)" Depreciation
Feb. 2009	Kazakhstan	Devaluation (18%)
Mar. 2009	Armenia	Devaluation (30%)
Mar. 2009	Switzerland	Devaluation (5%)
Mar. 2009	Vietnam	Widening of Exchange Rate Band
Apr. 2009	Singapore	Lowering of the trading band (<2%)
Apr. 2009	Fiji	Devaluation (20%)
Capital Account and Forex		
Date	**Country**	**Measure**
Oct. 2008	Iceland	Controls restricting foreign exchange purchases for essential items such as food, fuel and medicine. Eleven foreign currency acquired by domestic parties must be submitted to a domestic financial undertaking within two weeks. Other restrictions on capital movements.
Dec. 2008	Ukraine	Restriction on Forex Sales and Purchase. Parliament has voted in a first reading for a law that would force all exporters to convert their foreign currency earnings back into hryvnias.
Feb. 2009	Nigeria	Prevent foreign exchange dealing between banks
Feb. 2009	Venezuela	Limits on purchase of "Travel" Dollars
Mar. 2009	Angola	Tightening of Forex Controls
Mar. 2009	Kazakhstan	Approval of reading of new law in parliament on capital controls
Mar. 2009	Zambia	Ban on foreign borrowing in local currency and on the use of the US dollar or other forex in domestic transaction.
Mar. 2009	Vietnam	'Punishment' for bank trading outside the exchange rate band
Mar. 2009	Uzbekistan	Bank clients must use all foreign currency within seven days after purchasing it; otherwise they are obligated to sell it back to the banks.
Mar. 2009	Argentina	Lift of former capital controls from 2005
Apr. 2009	Bolivia	Bolivia's Central Bank is banning banks from buying or selling US dollars for much more or less than the official exchange rate.
Apr. 2009	Kazakhstan	Limitation on forex trading at exchange offices.

countries have been depreciating heavily (like the United Kingdom, Sweden, and Australia). Hence, the latter countries' gain in competitiveness has heightened the others' incentive to weaken their own currency. However, in no instance do the measures imply an extremely high loss of competitiveness for industrial countries. The exception is Japan that saw its ECI value climb by more than 20 percent in the last months of 2008 reflecting to some extent its appreciation against

the US dollar but also the appreciation with respect to major trading partners in Asia, in particular Korea, which after the United States and China is the most important export market of Japan. Hence, even though Korea's depreciation was market-driven it has increased the contagion risk for Japan to devalue.

A similar pattern can be observed in other Asian countries that did not experience a depreciation. In particular China, Singapore, and Hong Kong, and the Philippines have lost competitiveness in the last months of 2008. This may induce them to follow their regional competitors, which depreciated strongly including South Korea and Indonesia, and to a lesser extent India.

For Latin American countries, ECI values have dropped strongly throughout 2008 and in particular the second half of 2008. Brazil's competitiveness has recently improved, but not enough to offset earlier losses from the disinflation

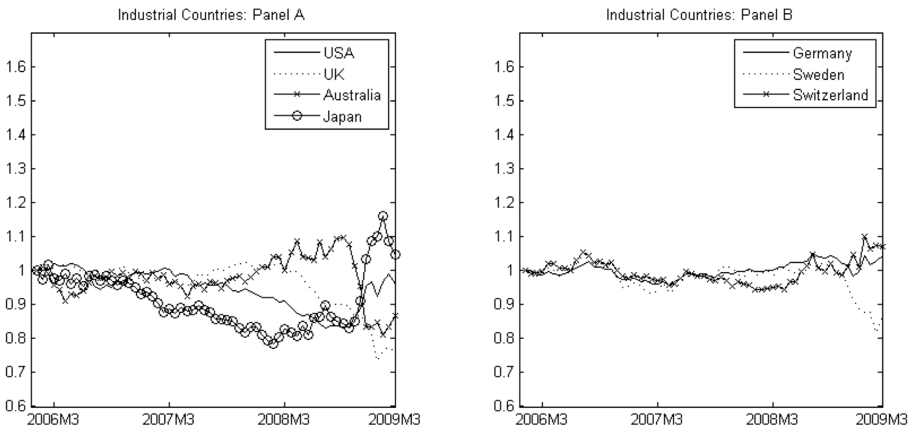

Figure 10.9: *ECI Values for Selected Industrial Countries*

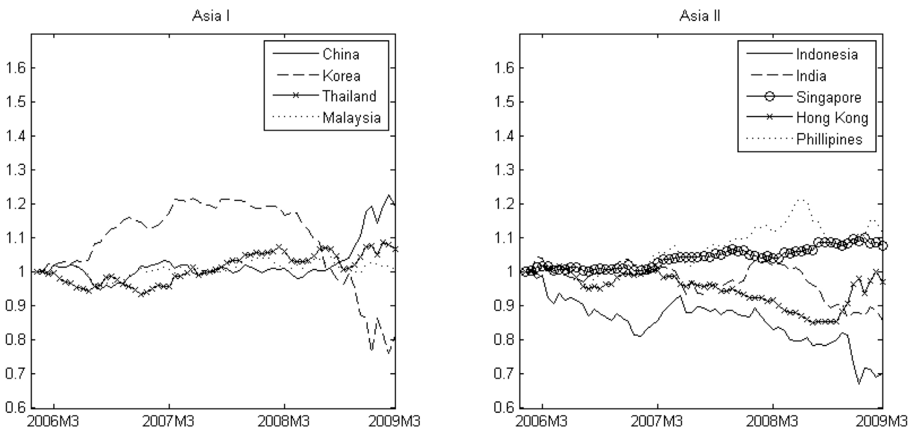

Figure 10.10: *ECI Values for Selected Asian Countries*

years fully. Chile, Venezuela and Argentina have rather low ECI values. Similarly, the recent depreciation of the Mexican peso contributed to a relatively low ECI. Hence, from Mexico and major exporters from Latin America there seems to be stemming no risk of contagion via the exchange rate devaluations since they have already a relatively competitive exchange rate with respect to their direct competitors.

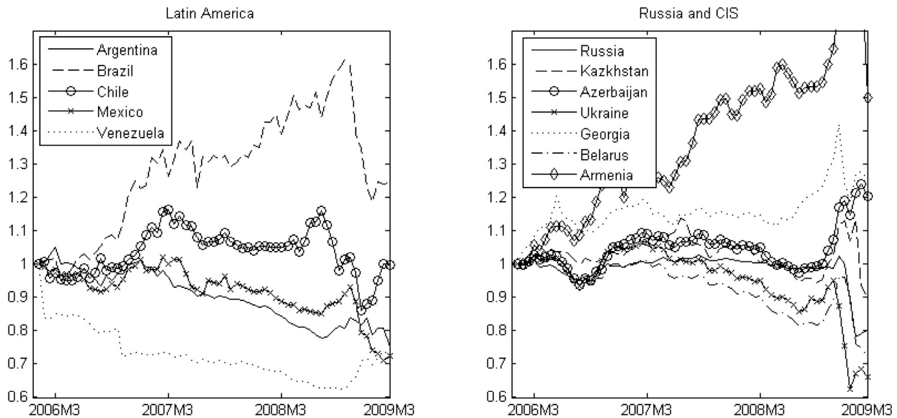

Figure 10.11: *ECI Values for Selected Latin American and CIS Countries*

From the major export nations stems only limited contagion incentives. These tend also to be limited to Asia. However, if Japan and China were jointly to devalue ECI values for several non-Asian countries, in particular Mexico, Canada, and most Latin American countries would increase significantly. This is due to the high share of Japan and China in US imports (>20 percent) and the high importance of the US market for Mexico, Canada, and Latin American countries with a share that exceeds often 80 percent of total exports. Hence, the highest risk of contagion stems from these two countries since they both have an incentive and are big enough to trigger retaliation by other countries.

4.2 Bottom-up contagion

While a devaluation by a major nation is more likely to trigger contagion, smaller nations may also be at the root of the process. Countries that are minor players in global trade can tip of a depreciation process via third-market competition effects. This could cumulate to take on a global significance once a crucial mass is reached. Since the end of 2008 several non-systemically important countries have been devaluing their currency, as Table 1 illustrates. These countries have been primarily raw material exporters.

A few developments in non-systemically important countries indicate that the threat of contagion remains relevant. The developments in Russia and the CIS provide an example of how contagion takes place and may continue. The man-

aged depreciation of the rouble and the devaluation of Ukraine raised the two countries' competitiveness (Figure 10.11). As consequence, Armenia, Georgia, Azerbaijan, and Kazakhstan lost between 10 and 30 percent of competitiveness as indicated by the jump in their ECI value. Belarus devalued in January followed by Kazakhstan in February and, Armenia in March 2009. Azerbaijan and Georgia did not follow suit yet, but their situation has become increasingly uncomfortable, with ECI values, being relatively high.

In Africa, the two largest economies have undergone sharp exchange rate fluctuations. After Nigeria's currency appreciated in 2008, leading to a loss of competitiveness, the central bank *allowed* the Naira to depreciate heavily (*circa* 25 percent) in the beginning of 2009. Nigeria is an important exporter to various West African states. The latter saw their ECI values increase with the one of Nigeria before the heavy depreciation of Nigeria. With the depreciation of the Naira several countries in the region lost somewhat in competitiveness, which increases in turn their incentive to devalue.

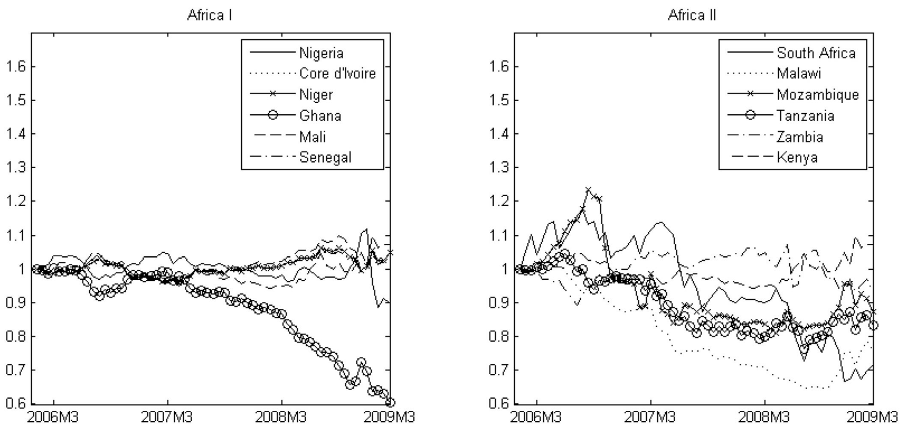

Figure 10.12: *ECI Values for Selected African Countries*

South Africa has also been depreciating by close to 25 percent since the end of 2007. Given South Africa's importance in many Southern African markets, like Mozambique, Malawi, Namibia, Zimbabwe and Zambia and to a lesser extent Tanzania and Kenya, a change in the value of the South African Rand directly impacts on these respective countries' competitiveness.[16] This is since South Africa is both a major destination for exports from other Southern African countries, but it makes also up for a major share in imports in these countries. In fact in the last three months of the sample the ECI value of South Africa drops heavily, while the respective values of Malawi and Mozambique rebounded upwards. Zambia and Kenya, though less affected by the recent changes, remain less competitive.

[16] However, some countries (including Namibia) peg to the South African Rand.

With the exception of the CIS there has been no other contagion yet. However, the exchange rate changes by some regionally important countries have put other small countries under increasing pressure. If such a trend continues the step to another regional contagion is not big and may trigger even reactions outside the region given the inter-linkages of trade patterns across the globe.

5. CONCLUSIONS EXPLORING POSSIBLE POLICY RESPONSES

Few countries so far have used direct foreign exchange interventions and there has only been one, regionally contained, case of contagion. Most of the recent strong exchange rate variations have been brought about by market forces and have not been the result of competitive devaluations. Nevertheless, some of these sharp exchange rate changes create difficulties for partner countries by altering adversely their competitiveness. However, it is close to impossible to give precise recommendations regarding the desired exchange rate movements, due to the combination of a numerous factors that require exchange rate adjustments and of very limited knowledge of what drives exchange rates and how they affect the economy.

5.1 Exchange rate regimes

The old case for flexible exchange rate has been controversial for so long that there is no hope of drawing firm conclusions. Paradoxically perhaps in the midst of extreme financial market dislocation, flexible currencies have tended to move in the right direction, if not by the right amount. Misalignments are more prevalent among *de facto* fixers. On the other side, if we fear beggar-thy-neighbour behaviour, lack of activism among the fixers could be seen as reassuring, unless it leads to deeper duress as the recession sets in.

An additional advantage of fixed exchange rates in the current situation is that it allows external observers to identify deliberate actions by the authorities. This allows the IMF to use the surveillance mechanism to discuss the issue with the authorities and, hopefully, to thwart or reduce damaging beggar-thy-neighbour actions.

Finally, exchange rate stability stands to enhance fiscal policy effectiveness. If as argued in Section 2.2 fiscal policy is going to be the main countercyclical instrument, stabilising exchange rates is desirable.

5.2 Global imbalances

Comparing recent changes and the initial current account position, there is no clear sign that exchange rates have moved to eliminate the global imbalances. Strong surplus countries have often seen their currencies depreciate or have deliberately devalued them. The awkwardness of the situation is that while a depreciating dollar would be helpful in the adjustment of global imbalances, at the same time there is resistance to a depreciating dollar since it implies a loss in national wealth for the surplus countries that have accumulated dollar-denominated assets. A dollar depreciation would also raise the adjustment burden for the Euro zone and Japan.

This means that there can well be a trade-off between exchange rate changes required to alleviate the crisis and those that would move in the direction of resolving the global imbalances. If one believes that the global imbalances are the source of the crisis, then the priority should go in that direction. If one sees the global imbalances as a separate problem resulting from fundamental disequilibria, the guiding principle should be in helping to bring the world effectively to the end of the recession.

5.3 Allocation of exchange rate adjustments

Because there is simply no way to allocate desirable exchange rate changes across countries, no such effort should be undertaken. Even among the key leading exporters, agreeing on an efficient burden sharing is unlikely to be feasible in theory, not to mention political considerations. On the other hand, our review of incentives to depreciate suggests that the risk is high that some authorities resort to beggar-thy-neighbour policies. Even though, so far, large exchange rate changes have not triggered any contagion (with the exception of the CIS), the risk that they will may well rise as governments run out of better options. To reduce the odds of conflictual use of exchange rates, some form of coordination is needed. We consider three possibilities.

First, all countries that operate a flexible exchange rate regime should agree to refrain from non-conventional monetary easing via the foreign exchange market. Similarly, countries with fixed exchange rates – no matter how fixed they are – should not undertake any depreciation without in-depth consultations with the IMF.

Second, when market pressure threatens a currency, whether the exchange rate floats or is fixed, IMF support should be sought and provided. Lending should come along with the conditions that ensure a behaviour that is consistent with the external balance and repayment capability, but should not be encompassing any other dimension. If conditionality is too broad, many countries could be reluctant to opt for IMF support and could prefer instead to act unilaterally. The recently created Flexible Credit Facility should be offered to most countries that had achieved a reasonable degree of policy discipline before the crisis.

Finally, capital controls need to be monitored to avoid measures which interfere with trade and may backfire. Capital controls have been used partly to complement the exchange rate adjustments (Iceland, Ukraine, Kazakhstan, Vietnam, and Angola) and partly as a substitute for such adjustments (Nigeria, Venezuela, Zambia, and Bolivia). In the first case, the controls often serve as a means to defend the newly established exchange rate value, while, in the second case, they serve to limit market pressure and to avoid a rapid depletion of foreign exchange reserves. If effective, temporary capital controls can be helpful. But they can also cause disruptions and hamper the allocation of funds. Indeed, black markets have been on the rise in most of the nations that implemented the capital controls, undermining the controls and supporting illegal activities leaving little but a premium on the transaction behind. Additionally, controls that require exporters to convert foreign currency revenues into local currency within a short period are

likely to disrupt trade in an environment where revenues and expenditures do naturally not coincide and where exporters are paying part of their imports and required services in foreign currency. Capital controls can be beneficial if geared at short-term financial capital outflow (like liquidation of equity investment) but may be doing more harm than good if affecting the regular foreign currency requirements of exporters and importers.

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APPENDIX 1

Table A10.1: *Data Sources*

Variable	Source	Variable	Source
Tables		**Annual data for the Regression**	
Exports		REER, CPI and Reserves	IFS
Current Account		RER	Own calc. (IFS)
Public Debt	CIA Factbook	CA Openness	Chinn and Ito
Interest Rates	Central Banks	Gov. Share	
Infl. and GDP growth forecast	EIU	GDP, P-Level, Trade Open.	WB WDI
Reserves and Nom. Ex. Rate	IFS	**ECI computation**	
NEER and REER	BIS	Bilat. Trade	COMTRADE
Current GDP and GDP growth	IMF WEO	Nom. Exchange Rate	IFS

Data come from various sources.

APPENDIX 2: THE ESTIMATION OF THE REAL EQUILIBRIUM EXCHANGE RATE

The estimation of the real equilibrium exchange rate is based on an extended PPP approach similar to Cheung et al. (2008). The particular approach chosen here is based on the consideration that the evolution of the real exchange rate is a function of (slow-moving) factors affecting the equilibrium exchange rate X_{it}; and factors which in the short- to medium- run lead to a deviation from the equilibrium rate, of which we attempt to explain a part by policy variables Z_{it}. We consider the remainder as the random unexplained part (e_{it}):

$$RER_{it}=\alpha_i+\beta X_{it}+\gamma_i Z_{it}+\varepsilon_{it}$$

However, we do not impose slope homogeneity on the policy variable, but let it instead vary by country.[1] The equilibrium rate is given by:

$$\mathrm{RER}_{it}=a_i+bX_{it}+y_i\underline{Z}_i$$

where $\underline{Z}_i$ is the average value of the policy variable for country *i*. The standard misalignment measure is given by:

$$\mathrm{MISA}_{it}=RER_{it}-\mathrm{RER}_{it}=y_i(Z_{it}-\underline{Z}_i)+e_{it},$$

or in percentage, reflecting the extent of misalignment (that is,over-valuation):

$$\mathrm{SMISA}_{it}=(RER_{it}/\mathrm{RER}_{it}-1)*100=100*[y_i(Z_{it}-\underline{Z}_i)+e_{it}]/\mathrm{RER}_{it}.$$

[17] This is similar to an analysis in which we would have discarded the policy variables altogether from the estimation (as is done in most applications) and then analyse the error country by country. The problem with such an approach is that it leads to a missing variable bias and cannot be performed by simply correlating the residual with the policy variable in a second step.

For the empirical implementation we use the following controls X_{it}=($PROD_{it}$, $OPEN_{it}$, $KAOPEN_{it}$, GOV_{it}). $PROD_{it}$ is the traditional Balassa-Samuelson effect; that the equilibrium rate moves with increased development, since the tradeable goods sector is driving growth. The measure we employ is the GDP per capita in current US dollars relative to the United States.[18] $OPEN_{it}$ stands for the extent to which the country is integrated in the world market allowing for cheaper imports and hence a lower price level. Our proxy is the sum of exports and imports over GDP. $KAOPEN_{it}$ is the index by Chinn and Ito (2006). GOV_{it} stands for the size of the government, which is assumed to increase the relative importance of non-tradeables in domestic consumption leading to a more appreciated exchange rate. We measure GOV_{it} by the government consumption share in GDP. The policy variable is given by Z_{it}=RES_{it}, which stands for the reserve to GDP ratio. All variables are in logs except for the $KAOPEN_{it}$ index.

Table A10.2: *Estimation Results*

X:\ RER:	P-Lev.	P-Level	P-Level	RER	RER	REER	REER
PROD	0.22***	0.59***	0.63***	0.39***	0.44***	0.36***	0.34***
OPEN	–0.11***	–0.17***	–0.13***	–0.24***	–0.24***	–0.25***	–0.21***
GOV	0.08***	0.04***	0.04***	0.06***	0.07***	0.08***	0.07***
KAOPEN	0.00	0.02***	0.01***	0.004*	0.00	0.01*	0.00
Z	No	No	Yes	No	Yes	No	Yes
Fixed Ef.	No	Yes	Yes	Yes	Yes	Yes	Yes
N. of Obs.	2900	2900	2868	3287	3249	1928	1914
N. of Ctry	(152)	(152)	(151)	(153)	(152)	(89)	(89)
R2 (within)	0.68	0.68	0.84	0.46	0.64	0.45	0.58

[18] We also employed the PPP measure as robustness check without finding any major difference. More information on the estimation and the results are available on request.

APPENDIX 3: THE EXTERNAL COMPETITIVENESS INDEX (ECI)

The external competitiveness index is similar to the concept of a nominal effective exchange rate. But rather than contrasting the relative competitiveness of exports to imports, it compares the competitiveness of the own exports relative to the exports of the competitors in third markets. The value is computed in two steps. In a first step the competitiveness in all major export markets *k* is determined by subtracting from country *i*'s appreciation against currency *k* the weighted appreciation of all other exporters' appreciations against currency *k*

$$\Delta MCI_t^{i,k} = \Delta E_t^{i,k} - \left(\frac{1}{1 - \mu_{i,k}} \right) \sum_{j \neq i} \mu_{j,k} \Delta E_t^{j,k}$$

where the weights are given by the respective market share of exporter *j* in market *k* adjusted by the market share of country *i* in market *k*, such that the sum of the shares adds up to unity. The overall index change is the weighted relative appreciation in the export markets as given by:

$$\Delta ECI_t^i = \sum_{k \neq i} \omega_{i,k} \Delta MCI_t^{i,k}$$

where the weights are given by the relative importance of market *k* for total exports of country *i* which sum to unity. The depicted index is calculated by defining a base year at which all indicators are normalised to unity and then computed according to:

$$ECI_{T_0,T}^i = \prod_{t=T_0}^{T} \left(1 + \Delta ECI_t^i \right)$$

The weights are computed using constant 2006 trade shares. The sample includes 137 exporting and (or) importing countries.

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11

Restrictions on Mode 4 Access: Recent Evidence

BISWAJIT DHAR AND GIRISH SRIVASTAVA

1. INTRODUCTION

The downturn that the global economy has been experiencing for nearly a year has appeared more enduring now that its effect is being felt on the global trade flows. The World Trade Organization (WTO) has recently reported that "the collapse in global demand brought on by the biggest economic downturn in decades will drive exports down by roughly 9 percent in volume terms in 2009, the biggest such contraction since the Second World War".[1] While the decline in developing countries' exports was expected to be much lower than those of the developed countries, the former set of countries could eventually be worse off since many among them have high dependence on export earnings that have dwindled in the aftermath of the crisis.

The bleak predictions of the WTO Secretariat on prospects for global trade during the current year appear to be extremely realistic, given the sharp increase in protectionist tendencies in recent months. The Report of the WTO Director-General to the Trade Policy Review Body on the financial and economic crisis and the trade-related developments increase has brought out the fact that WTO Members have resorted to increases in border protection measures through higher levels of tariffs and the imposition of new non-tariff measures. Besides, these countries have also increased the use of trade defence measures such as antidumping actions. The report further observed that while the financial and fiscal stimulus packages that have been introduced to tackle the crises have generally included elements which could help restore the rate of growth of global trade, some of these packages include elements – state aids, other subsidies and 'buy/lend/invest/hire local' conditions – that favour domestic goods and services at the expense of imports. The increase in the protectionist sentiments as is reflected by the above-mentioned measures should cause consternation, particularly because

[1] WTO (2009), "WTO sees 9 percent global trade decline in 2009 as recession strikes", Press Release, 22 March; accessed from: http://www.wto.org/english/news_e/pres09_e/pr554_e.htm.

these measures have been adopted by most of the prominent members of the WTO.[2]

The above-mentioned developments have been viewed with considerable trepidation as they threaten to stymie the benefits that expansion of trade flows between countries has brought with it over the past two decades. Trade expansion had provided the trigger for enhanced integration of economies during the past two decades, and this in turn contributed to the rising economic fortunes in large swathes of the world. Although there have been pockets of disenchantment in the developing world in particular, it was widely felt that the problems of those voicing concerns could be addressed through further deepening of global economic integration. A major contribution in realising this objective was expected from the ongoing Doha Round of multilateral trade negotiations, which was to provide a framework for widening the scope of economic integration.

For most developing countries, the Doha mandate for liberalising trade in services brought with it expectations that temporary movement of natural persons, or Mode 4, in which these countries have substantial export interests, would witness meaningful liberalisation. And because trade in services under Mode 4 has historically been the most protected among the four modes of supply of services, the potential suppliers of Mode 4 services had high expectations from the Doha Round. However, belying the expectations of a majority of WTO Members little progress has been made in the Doha Round on Mode 4 issues. The developed countries have remained reluctant to take additional commitments to allow greater market access under Mode 4. Ironically, this has happened even as the WTO membership recognised that there exists asymmetry of commitments in Mode 4 compared to other modes of supply[3] that can be addressed through improved commitments.[4]

Given the sensitivities of the developed countries in allowing temporary movement of natural persons from other WTO Members in their territories[5], it was hardly surprising that the economic downturn would bring with it renewed attempts by the potential importers of Mode 4 services to raise import barriers. In this context it needs to be pointed out that while much attention has been given to the protectionist measures taken by countries, which have affected global trade in goods and some of the more prominent services, relatively little attention has been paid to the restrictions being imposed on Mode 4 services. And this has happened notwithstanding the fact that in the early days of the economic down-

[2] Many WTO Members are facing increased pressure to take protectionist actions. At the start of this year, most WTO Members appeared to have successfully kept these pressures under control. Thirty-three WTO Members (individual EU Members are not counted) had taken the measures to stimulate their economies and also to protect their domestic industries from facing import competition. For details see, WTO (2009) "Report to the TRPB from the Director General on the Financial and Economic Crisis and Trade-related Developments", JOB (09)/30, 26 March.

[3] WTO (2007), Communication from China, India, Pakistan, Peru, and Thailand – Liberal Mode 4 Commitments: A win-win for all Members, JOB (07)/175, 12 November 2007, paragraph 20.

[4] This issue was highlighted in the Hong Kong Ministerial Conference of the WTO in 2005. For details, see WTO (2005), Doha Work Programme: Ministerial Declaration, WT/MIN (05)/DEC, 22 December 2005.

turn, Juan Somavia, Director General of the International Labour Office warned that the "current global financial and economic crises have serious implications for migrant workers worldwide".[6] Perhaps more importantly, Somavia reminded the global community of past experience which showed "that migrant workers, especially women workers and those in irregular status, are among the hardest hit and most vulnerable during crisis situations".[7]

The relative neglect of problems faced by suppliers of Mode 4 services has been glaringly evident in the statements made by global leaders opposing the advent of the 'new protectionism'. These leaders have voiced their concerns about the adverse impact of the economic downturn on labour through reduced employment opportunities, but they failed to recognise that the foreign workers have faced extremely adverse conditions, as countries have adopted policies to ensure that the interests of the local workers are given preference over those of their counterparts from other countries.[8]

This chapter is an attempt to capture some of the more prominent measures to restrict access to Mode 4 services that have taken place since the onset of the economic downturn. It must be mentioned here that its focus is only on the measures that are being taken by countries to restrict fresh inflow of foreign workers through enhanced levels of domestic regulation. Also, the chapter does not consider the impact of the policies adopted in response to the crises on the existing foreign workforce because sufficient evidence is lacking.

The chapter has two sections. At the outset, the restrictions already imposed or that are proposed to be imposed on the import of Mode 4 services are enumerated in detail. As stated earlier, these measures have been taken at a time when the global community of nations is engaged in the process of resurrecting the now-stalled Doha Round of multilateral trade negotiations, which was intended to provide a fillip to the process of liberalising trade in services. The following section provides an assessment of the measures taken, especially by the US Administration, to restrict the level of Mode-4 access.

2. RESTRICTIONS ON MODE-4 ACCESS: THE RECENT EVIDENCE

This section focuses on the restrictions imposed by the United States and the European Union Member Countries, particularly since the onset of the current phase

[5] Hoekman and Mattoo (2007, 9) have commented that "mode 4 is politically extremely sensitive".

[6] International Labour Office (2008), Message by Juan Somavia, Director-General of the International Labour Office on the occasion of International Migrants Day, 18 December 2008; accessed from: http://www.ilo.org/public/english/bureau/dgo/speeches/somavia/2008/migrants.pdf.

[7] International Labour Office (2008), Message by Juan Somavia, Director-General of the International Labour Office on the occasion of International Migrants Day, 18 December, 2008; accessed from: http://www.ilo.org/public/english/bureau/dgo/speeches/somavia/2008/migrants.pdf.

[8] The G20 Summit held in April, 2009 and the London Jobs Conference did not comment on imperative to keep the market for Mode 4 services as an essential step to create more jobs and therefore additional demand in economies that is essential for reversing the economic downturn faced by most countries. See, G20 (2009), The Global Plan for Recovery and Reform, 2 April 2009

of economic downturn, which have adversely affected temporary movement of persons. These trans-Atlantic economies are the two largest importers of Mode 4 services and therefore measures taken by them can have far-reaching implications on the global market for this mode of service transactions. At the outset, we discuss the details of the measures that have been taken by the US Administration to introduce stricter regulations on Mode 4 service providers. In a subsequent section, we discuss the situation in this regard emerging in the EU Member Countries.

2.1 Measures introduced and (or) proposed by the United States to regulate Mode-4 Access

The most pervasive restrictions on temporary movement of persons under Mode 4 have been proposed by the policy makers in the United States. These restrictions have been introduced as a part of the economic stimulus package. More recently, additional measures to restrict entry of temporary workers in the United States have been proposed in the H-1B and L-1 Visa Reform Act 2009[9], a narrowly tailored bipartisan legislation that is aimed at preventing 'abuse and fraud' and to 'protect American workers'. This proposed legislation includes a stronger enforcement regime in respect of H-1B visas. Complementing the initiatives taken in this proposed legislation are measures that are being taken by the Department of Homeland Security (DHS) to introduce robust employer enforcement as a critical part of the US immigration system[10]. These measures are ostensibly aimed at deterring foreign workers from participation in the US economy, and as we shall discuss later, the measures are already affecting the nature of participation in the H-1B program.

The first set of restrictions on H-1B beneficiaries was included in the stimulus package introduced by the Obama Administration through the *American Recovery and Reinvestment Act* (ARRA). The ARRA, which was signed into law in February 2009, included the *Employ American Workers Act* (EAWA) that introduced conditions on hiring foreign nationals to work in the H-1B "specialty occupation[11]" category by employers receiving funds through the *Troubled Asset Relief Program* (TARP) of the *Emergency Economic Stabilization Act* of 2008 (EESA). It must be mentioned here that the initial goal of the proponents of the EESA was to prohibit TARP recipients from employing H-1B workers. The legislation which was eventually adopted allows such employment by firms receiving TARP funds subject to a number of conditions. These conditions are not imposed on most firms that did not receive Federal funds under the stimulus package.

[9] US Senate (2009), S. 887, 111th Congress, April 23.

[10] Department of Homeland Security (2009), Testimony of Secretary Napolitano before the Senate Committee on the Judiciary, Oversight of the Department of Homeland Security, May 6; accessed from: http://www.dhs.gov/ynews/testimony/testimony_1241706742872.shtm.

[11] According to the US Citizenship and Immigration Services (USCIS), "specialty occupation" is one that requires theoretical and practical application of a body of specialised knowledge along with at least a bachelor's degree or its equivalent.

All H-1B workers 'hired' by a covered employer between February 17 2009 and February 16 2011 are covered by the EAWA. Petitions covered by this Act include those filed for new hires whose petitions were approved before the date EAWA became effective. The EAWA does not apply to petitions to change the status of a foreign worker already working for the employer in another work-authorised category or to those seeking an extension of stay for a current employee for the same employer.

It is important to note here that the EAWA limits the applicability of the requirements described above as the 'hire' of H-1B workers. The term 'hire', according to ARRA, is "to permit a new employee to commence a period of employment". This provision thus seeks to clarify that the conditions on the hiring of H-1B workers does not to apply to existing employees of an organisation.

Under EAWA, firms seeking to hire employees under the H-1B visa program would be considered 'H-1B dependent employers' if they are receiving TARP funds. The concept of 'H-1B dependent employers' was first introduced in the H-1B program in 2001, as a transitory measure, and was reintroduced in 2005 after it was included in the H-1B *Visa Reform Act* of 2004. This regulation provides that for employers having 51 or more full-time equivalent employees, the 'H-1B dependent employers' would be those having 15 percent or more H-1B workers.[12]

The restrictions on the employment of non-immigrant workers introduced by the EAWA imply that TARP recipients are now subjected to the same rules as 'H-1B dependent employers' regardless of the share of H-1B workers in their total workforce. Thus, while the new regulations do not put a blanket ban on the hiring of H-1B workers who are TARP recipients, they do, however, impose several conditions that would have the effect of discouraging employers from engaging non-immigrant workers, as is brought out in the following discussion.

The EAWA requires that all 'H-1B dependent employers' must make the following additional attestations to the US Department of Labor (DOL) when filing a Labor Condition Applications (LCA):

(i) They have taken good faith steps to recruit US workers[13] using industry-wide standards and offering compensation that is at least as great as offered to the H-1B non-immigrant;

(ii) They have offered the job to any US worker who applies and is *equally or better qualified* for the job that is intended for the H-1B non-immigrant (emphasis added);

[12] For smaller companies, i.e. those having less than 50 employees the number of H-1B employees that must employ to be considered as "H-1B dependent" are the following: (i) at least eight H-1B non-immigrant workers for employers employing 25 or less full-time equivalent employees and (ii) least 13 H-1B non-immigrant workers for employers employing 26–50 full-time equivalent employees.

[13] Defined as nationals, or US citizens, lawful permanent resident aliens, refugees, asylum seekers, or other immigrants authorised to be employed in the United States (that is, workers other than non-immigrant aliens).

(iii) They have not 'displaced' any US worker employed within the period beginning 90 days prior to the filing of the H-1B petitions and ending 90 days after their filing. The conditions clarify that a US worker is deemed to have been displaced if the worker is laid off from a job that is *essentially the equivalent of the job*[14] for which an H-1B non-immigrant is sought (emphasis added); and

(iv) They would not place an H-1B worker to work for another employer unless it has inquired as to whether the other employer has displaced or is likely to displace a US worker within 90 days before or after the placement of the H-1B worker.

In a further tightening of regulations underlying movement of persons under Mode 4, the EAWA removes an important exception that was hitherto available to H-1B dependent employers. The earlier rules provided an exemption from the extra attestations for H-1B workers who possess master's degrees or who receive wages of at least $60000; the EAWA makes this exemption unavailable to TARP recipients.

In addition to the aforementioned, an employer subject to the new regulations is prohibited from placing the H-1B worker with another employer in situations where there is any indication of a relationship between the worker and the other employer, unless the new 'receiving' employer has not displaced a US worker within 90 days before or after the non-immigrant is placed. This, in other words, implies that the employer cannot outsource any H-1B worker to work for another employer unless that employer first makes a *bona fide* inquiry as to whether the other employer has displaced, or has the potential of displacing, a US worker within 90 days before or after the placement of the H-1B worker.

The conditions imposed on the H-1B dependent employers could put the TARP beneficiaries in a cleft stick, thus affecting their prospects of a turnaround from the present economic downturn. This situation could arise as many financial institutions, the sector that has received the largest share of the TARP funds, have been experiencing workforce reduction, but since they are receiving Federal relief funds they would be prevented from hiring new employees in H-1B category.

The pitch on the issue of restricting the inflows of non-immigrant workers in the United States has been queered by the recent move by two Congressmen, Assistant Senate Majority Leader Dick Durbin and Senator Chuck Grassley, to introduce the *H-1B and L-1 Visa Reform Act* 2009 (henceforth, 'Durbin-Grassley Bill'). Durbin and Grassley have introduced narrowly tailored bipartisan legislation that seeks to amend the *Immigration and Nationality Act* to prevent "abuse and fraud" and to "protect American workers".[15] Providing the *raison d'être* for the bill that he had co-sponsored, Senator Durbin stated that the H-1B visa pro-

[14] A job is considered as the essential equivalent of another job if it involves essentially the same responsibilities, was held by a US worker with substantially equivalent qualifications and experience, and is located in the same area of employment as the other job.

[15] US Senate (2009), S. 887, 111th Congress, April 23.

gram had not realised its stated objective: "to benefit the American economy by allowing US employers to import high-skilled and specialised guest-workers when no qualified American workers are available".[16] In other words, the H-1B visa program was expected to complement the US workforce, and not replace it. Durbin argued that "the H-1B visa program is plagued with fraud and abuse and is now a vehicle for outsourcing that deprives qualified American workers of their jobs", and the bill he had co-sponsored was therefore designed to "put a stop to the outsourcing of American jobs and discrimination against American workers". The proposed bill, Durbin clarified, was aimed at making reasonable reforms by plugging the loopholes that, in his view, have allowed foreign guest workers to displace qualified American workers. And, this was to be done, according to the author of the proposed legislation, by keeping unaltered the number of H-1B visas that are currently available.

Durbin sought endorsement of his position in the assessment made by the US Department of Labor (DOL) on the operation of the *H-1B Work Visa for Specialty Occupations* program during 2002–6. In its assessment, the DOL had stated that the "H-1B workers may be hired even when a qualified US worker wants the job, and a US worker can be displaced from the job in favour of a foreign worker".[17] Durbin has interpreted this assessment by DOL as saying that employers can legally discriminate against qualified Americans by firing them without cause and recruiting only H-1B guest workers to replace them. Some companies that discriminate against American workers are so brazen that their job advertisements say 'H-1B visa holders only'. And some companies in the United States have workforces that consist almost entirely of H-1B guest workers. Employers can legally discriminate against qualified Americans by firing them without cause and recruiting only H-1B guest workers to replace them.

To address the problems that have been outlined above, the Durbin-Grassley Bill proposes to introduce the following conditions on the employers[18]:

(i) Require all employers who want to hire an H-1B guest worker to make a good-faith attempt first to recruit a qualified American worker. Employers would thus be prohibited from using H-1B visa holders to displace qualified American workers.
(ii) Prohibit the blatantly discriminatory practice of 'H-1B only' ads and prohibit employers from hiring additional H-1B and L-1 guest workers if more than 50 percent of their employees are H-1B and L-1 visa holders.

Effective monitoring of the H-1B and L-1 visa programs is yet another focus of the Durbin-Grassley Bill. The bill seeks to respond to the view that under current law, it is very difficult for the Federal government to monitor the program. It has

[16] Durbin, Grassley Introduce Legislation to Reform H-1B Visa Program, April 23, 2009; accessed from: www.durbin.senate.gov/showRelease.cfm?releaseId=311910.

[17] US Department of Labor (n.d.), Strategic Plan 2006–2011, Washington DC., 35; accessed from: http://www.dol.gov/_sec/stratplan/strat_plan_2006-2011.pdf.

[18] The following discussion is based on the provisions of the proposed Durbin-Grassley Bill.

been argued that the Department of Labor (DOL) is only authorised to review applications for completeness and obvious inaccuracies, and that the department does not have the authority to open an investigation of an employer suspected of abusing the H-1B program unless it receives a formal complaint – even if the employer's application is clearly fraudulent. According to Durbin, these deficiencies in the monitoring system have prompted the DOL's Inspector General to conclude that the H-1B program is "highly susceptible to fraud".

To address the above-mentioned issue, the Durbin-Grassley Bill proposes to give the government more authority to conduct employer investigations and streamline the investigative process. For example, the bill would:

(i) Permit DOL to initiate investigations without a complaint and without the Labor Secretary's personal authorisation;
(ii) Authorise DOL to review H-1B applications for fraud;
(iii) Allow DOL to conduct random audits of any company that uses the H-1B program;
(iv) Require DOL to conduct annual audits of companies who employ large numbers of H-1B workers.

The Durbin-Grassley Bill also seeks to influence the participation of H-1B non-immigrants through an elaborate wage determination system, one that imposes onerous requirements on the potential employers. The proposal in this regard states that during the period of authorised employment for each H-1B worker, the employer will offer wages that are determined based on the best information available at the time the application is filed, and which are not less than the highest of the following benchmarks:

(i) The locally determined prevailing wage level for the occupational classification in the area of employment;
(ii) The median average wage for all workers in the occupational classification in the area of employment; and
(iii) The median wage for the skill level in the occupational classification found in the most recent *Occupational Employment Statistics* survey.

In addition, the employer would provide working conditions for the H-1B non-immigrant that will not adversely affect the working conditions of other workers similarly employed. These detailed conditions increase the burden on the potential employers of H-1B non-immigrants because of the compliance measures that have been included. The compliance measures include the following:

(i) Conduct annual compliance audits of not less than 1 percent of the employers that employ H-1B non-immigrants during the applicable calendar year;
(ii) Conduct annual compliance audits of each employer with more than 100 employees who work in the United States if more than 15 percent of such employees are H-1B non-immigrants; and
(iii) Make available to the public an executive summary or report describing the general findings of the aforementioned audits.

It is clear from the above discussion that the explicit intent of the Durbin-Grassley Bill is to introduce regulatory impediments in the process of employing H-1B non-immigrants. The employers would be have to bear significant administrative costs while seeking to employ the non-immigrants that could, in effect, dissuade them from employing such workers.

The impact of the restrictions that have been imposed by the US Administration on the entry of non-immigrant workers is already being felt. Beginning on April 1 each year, the US Citizenship and Immigration Services (USCIS) receives H-1B petitions for filling the Congressionally mandated cap of 65000 visas, which are issued to non-immigrant workers for joining the workforce the following year. In 2008, the USCIS had received enough applications to meet H-1B quota within a week of accepting the petitions, while in 2007, the number of applications reached 150000 in the first two days. In the current year, however, the experience has been radically different. On May 18 2009, USCIS announced that it had received approximately 45500 H-1B petitions counting toward the Congressionally mandated 65000 cap for the year 2010.[19]

2.2 The European context

In contrast to the slew of initiatives that have been taken in the United States to introduce stricter regulation on the entry of non-immigrant workers, thus affecting Mode 4 access, the members of the European Union have maintained their commitment towards providing a policy environment that seeks to enhance participation of foreign workers in their territories. In fact, EU Members have emphasised that "legal migration will play an important role in enhancing the knowledge-based economy in Europe, in advancing economic development", thus helping to realise the objectives of the Lisbon strategy that was aimed at making the European Union "the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment by 2010".[20]

During the past two years, the EU Members have been engaged in a process of introducing enhanced transparency in the provisions determining entry of foreign workers in their territories, which was seen as a cornerstone of a comprehensive immigration policy for Europe. Towards this end, the European Commission introduced in October 2007, a proposal for a "Council Directive on a single application procedure for a single permit for third-country nationals to reside and work in the territory of a Member State and on a common set of rights for third-country workers legally residing in a Member State" that was adopted by the European

[19] USCIS (2009), "USCIS Updates Information on FY2010 H-1B Petition Filings", 18 May; accessed from: http://www.uscis.gov/portal/site/uscis/menuitem.5af9bb95919f35e66f614176543f6d1a/?vgnextoid=cd684e44d6551210VgnVCM1000004718190aRCRD&tvgnextchannel=c94e6d26d17df110VgnVCM1000004718190aRCRD.

[20] Council of the European Union (2004), Brussels European Council: Presidency Conclusions 4/5 November, 19; accessed from: http://ue.eu.int/uedocs/cmsUpload/EU_4.5-11.pdf.

Parliament in November 2008.[21] More recently, in April 2009, the European Parliament adopted a resolution that underlines the principles, actions, and tools for formalising the *Common Immigration Policy for Europe*.[22]

But while the EU Members have collectively strived to provide a more predictable environment for foreign workers, the United Kingdom has taken a different view on the involvement of foreign workers in its economy, particularly since the onset of the economic downturn. The initial steps to introduce enhanced restrictions on the entry of foreign workers in the United Kingdom was taken in February 2008 when the UK Border Agency launched the "new immigration system ... to ensure that only those with the right skills or the right contribution will be able to come to the United Kingdom to work and study". This new policy was based on the "Points Based System"[23] that included five tiers of non-immigrants based on their levels of skills. The first two tiers include skilled workers: highly skilled individuals who can contribute to economic growth and productivity were included in Tier 1, while Tier 2 included skilled workers with a job offer who can fill gaps in the labour force. Tier 3 included low-skilled workers, while Tiers 4 and 5 included students and other workers who are allowed to work in the United Kingdom for a limited period.

Major amendments were introduced by the UK Border Agency in early 2009 in the points-based system that were specifically aimed at restricting access to workers included in Tiers 1, 2 and 3. The first move was to suspend Tier 3 of the PBS to ensure no foreign national from outside the European Economic Area (EEA)[24] can come to the United Kingdom and work in a low-skilled job. The more egregious of the measures proposed in early 2009 took the form of "measures to raise the bar for foreign workers wishing to enter the United Kingdom, and to give domestic workers a greater chance of applying first for United Kingdom jobs".[25] The UK Border Agency has announced three significant changes to support British workers and to be more selective about the migrants coming to the United Kingdom from outside the EEA. The new proposals specifically target Tier 1 and 2 migrants; that is, those that have high levels of skills.[26]

[21] Commission of the European Communities (2007), "Proposal for a Council Directive on a single application procedure for a single permit for third-country nationals to reside and work in the territory of a Member State and on a common set of rights for third-country workers legally residing in a Member State", COM(2007) 638 final, October.

[22] European Parliament (2009), A Common Immigration Policy for Europe, 22 April; accessed from: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2009-0257+0+DOC+XML+V0//EN.

[23] UK Home Office (2006).

[24] The EEA is defined as the European Union (EU) member states with the addition of Iceland, Norway and, for the purposes of immigration, Switzerland through a bilateral agreement. Workers of these additional countries possess the same rights to work in the United Kingdom as EU nationals. The ten new members of the EU that were inducted since 2004 do not, however, form a part of the EEA – separate immigration rules are applied for nationals of these countries.

[25] UK Border Agency (2009), Migrant workers face tougher test to work in the United Kingdom, 22 February; accessed from: http://www.ukba.homeoffice.gov.uk/sitecontent/newsarticles/migrantworkerstoughertest.

[26] This and the following information have been obtained from the UK Border Agency (www.ukba.homeoffice.gov.uk) and Mulberry Finch, an Immigration consultancy firm: (http://www.mulberryfinch.com/).

The new proposals represent the most drastic tightening of the Tier 1 Highly Skilled Migrants visa requirements to date. Under Tier 1, the current minimum educational qualification is a bachelors degree, but this is proposed to be raised to a masters degree under the proposals. Similarly, the minimum earnings requirement under the current rules is £17000, which will be raised to £20000. In recent years, over 25000 foreign workers have travelled to the United Kingdom each year under the Highly Skilled Migrant route. Available estimates indicate that the new requirements may reduce this number to fewer than 15000 per year.

The proposals also include the possibility of restricting Tier 2 Skilled Migrants work to skills shortage areas. Furthermore, Tier 2 Skilled jobs need to be advertised at Jobcentres to allow UK and (or) EU workers to have the opportunity to apply first, before a foreign national can be recruited. Almost 80000 migrants travel to the United Kingdom per year under the Tier 2 Skilled Migrant/Work Permit arrangements. This number would be halved under the proposals.

There is also a proposal to restrict migrants' dependants from taking up employment in the United Kingdom. This would prevent spouses and children of skilled migrants from working in the United Kingdom. The UK Border Agency will first have the economic contribution of skilled foreign workers' dependants assessed before taking a decision. This approach of the UK Border Agency is in the nature of a compromise, after the Home Secretary suggested the banning of foreign workers' families completely.

As in the case of the United States, the UK Administration has initiated steps to introduce regulatory impediments that would put sands in the wheels of temporary movement of persons under Mode 4. Although most of the measures that the UK Administration has proposed may not be implemented immediately, the introduction of these measures would have a large impact, given that in the recent years more than 100000 Tier 1 and 2 migrants were gaining access to the UK labour market.

3. AN ASSESSMENT OF THE MEASURES TAKEN TO RESTRICT MODE-4 ACCESS

Are the measures taken by the US Administration to restrict Mode-4 access as described above aimed at affecting the interests of the foreign service providers under Mode-4? The industry in countries like India that have utilised a large share of the H-1B visas granted in the past thinks that the United States has in fact undermined its own interests by taking such measures. The association representing India's interests in IT and ITES, *viz.* Nasscom, has argued that the H-1B visas have been used to provide technically qualified talent that is in short supply, to open new markets, and to accelerate innovation and increase competitiveness for US companies. Nasscom has therefore surmised that the stricter regulations accompanying the grant of H-1B visas and the *H-1B and L-1 Visa Reform Act* 2009 proposed by Durbin and Grassley would have a detrimental effect on the US economy by reducing its global competitiveness.

A recent study by the National Foundation for American Policy (NFAP) supports this view expressed by the Indian industry that the H-1B visa holders are important to innovation, entrepreneurship, and job creation in the United States.[27] The study has provided several interesting findings which contradict the view of the US policy makers that the restrictions on the grant of H-1B visas would, in the ultimate analysis, secure jobs for the US domestic workers during the economic downturn. Using the data provided by the technology companies in the S&P 500, the NFAP study shows that there is a positive and statistically significant association between the number of positions requested in H-1B labour condition applications (LCAs) and the percentage change in total employment. The results show that for every H-1B position requested, technology companies based in the United States were able to increase their employment by five workers. In other words, contrary to the assumptions made by the policy makers, there is a significant element of complementarity between the domestic workforce and the H-1B positions. The study further added that the degree of complementarity increased with smaller firms. In the case of technology firms with less than 5000 employees, each H-1B position requested in LCAs was associated with an increase of employment of 7.5 workers.

The NFAP study has the backing of a rich body of analytical literature that has argued that the removal of restrictions on Mode 4 brings with it gains for both importers and the exporters of such services. The study by Jansen and Piermartini[28] arrived at an important conclusion that temporary movements of persons can have positive and significant effects on merchandise trade. The estimates provided by the authors show that a 10 percent increase in Mode 4 services could increase US imports by around 3 percent and exports between 1.8 and 2.7 percent.

Subsequent studies by Walmsley and Winters (2005) and Walmsley, Winters and Ahmed (2007) demonstrated that removal of restrictions on the movement of natural persons would significantly increase global welfare with the benefits accruing to developing and developed countries. Walmsley and Winters showed that if skilled and unskilled temporary labour in the developed economies is increased by 3 percent of their labour forces, and the additional labour comes from developing economies, there would be global welfare gains of around $150 billion. Authors have also pointed out that there are significant gains to be made by all countries from the liberalisation of the movement of labour and that most of these gains accrue from the movement of unskilled workers.

Walmsley, Winters and Ahmed (2007) conclude in their study that if quotas on the number of temporary workers permitted into the developed economies are increased by 3 percent of the developed economies' labour forces, the real income

[27] National Foundation for American Policy (2009), "H-1B Visas by the Numbers", NFAP Policy Brief, March.

[28] Jansen and Piermartini (2004, 13).

of permanent residents in the developed economies increases significantly; most of those gains arise from the lifting of quotas on unskilled labour. The results provided by the authors show that permanent residents of developing countries also gain in terms of real incomes by exporting unskilled and skilled labour, although the gains from skilled labour could be less.

The studies referred to above unerringly point to the fact that the countries imposing restrictions on the temporary movement of natural persons may, in fact, adversely affect their interests. It is, therefore, ironical that these countries would be imposing such restrictions as a strategy to improve their economic fortunes.

4. BY WAY OF CONCLUSIONS

Temporary movement of natural persons under Mode 4, which has remained a contentious issue between the developed and the developing countries, got into further imbroglio as some of the major economies, including the United States and the United Kingdom have initiated measures that would effectively restrict entry of non-immigrant workers. Coming as it does in the midst of the economic downturn that has been deepened by the severe contraction of demand; these restrictive measures would impact on both the importers as well as the exporters of Mode 4 services. Ironically, however, the implications of the increasing restrictions on Mode 4 service suppliers have received much less attention in the on-going discussions centring on the economic downturn.

The relative neglect of this issue is more galling given the fact that although the global leaders, particularly those in the G20, have been cognisant of the contribution that open markets can make towards extricating the economies from the current morass, they have remained silent on the imperatives of keeping the market for Mode 4 services. In view of the growing tendencies to impose restrictions on the market for Mode 4 services it is imperative that the global leaders take cognisance of the role that this mode of services can play in the turnaround of the global economy. The positive impulses that liberalisation of Mode 4 could unleash on the global economy can be substantial given that this mode of service supply accounts for only 1 to 2 percent of the total trade in services.[29]

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[29] WTO (2007), paragraph 5.

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12

Foreign Direct Investment Protectionism is on the Rise

KARL P. SAUVANT*

1. THE RISE OF FDI AND THE NATURE OF THE INTERNATIONAL INVESTMENT REGIME

Foreign direct investment (FDI) is the most important vehicle to bring goods and services to foreign markets. World annual FDI inflows rose from an average of $50 billion during 1981–1985 to $1.9 trillion in 2007 (Figure 12.1);[1] in the case of a number of emerging markets, a good part of outward FDI is being undertaken by state-owned entities[2] (which, as will be discussed below, are subject to particular scrutiny in a number of countries). By the end of 2007, world FDI flows had accumulated to a stock of $15 trillion, controlled by over 80 thousand multinational enterprises (MNEs) that have more than 800 thousand foreign affiliates. World FDI flows declined in 2008 by 15 percent because of the financial crisis and recession; they will decline further in 2009, perhaps by as much as 50 percent.[3] Even with this decline, however, the level of FDI flows is significantly above that of the 1980s and the stock of this investment keeps growing: as long as flows are positive, the stock of FDI – and hence the importance of international production – increases.

The total sales of foreign affiliates amounted to $31 trillion in 2007, which compares with world exports of $17 trillion in the same year. In addition, the

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[1] Unless otherwise indicated, the data in this section are from UNCTAD (2008), *World Investment Report* (Geneva: UNCTAD, 2008) or the Organization's IIA database.

[2] In the case of China – the biggest outward investor among emerging markets – state-owned enterprises accounted for 83 percent of OFDI flows in 2005; by the end of 2005, their share of OFDI stock was 84 percent. See Leonard K. Cheng and Zihui Mahttp://www.nber.org/books_in_progress/china07/cwt07/cheng.pdf (2007). (These figures do not include FDI by state-owned enterprises administered by regional governments.) The Government of China, through its 'Going Global' policy, is actively supporting OFDI from China. Like their competitors from other countries, Chinese firms rely more and more on mergers and acquisitions when entering foreign markets, as opposed to Greenfield investment.

[3] UNCTAD (2009a), *Assessing the Impact of the Current Financial and Economic Crisis on Global FDI Flows*, Geneva: UNCTAD, 2009.

emergence of international production networks established by MNEs helps to integrate national production systems; this is not only reflected in the ownership and control ties that are established, but also in the fact that about one-third of world trade consists of intra-firm trade, that is, trade among the various units of the same corporate systems located in different countries. All this makes FDI an important source of capital, technology, know-how, and access to markets – all tangible and intangible assets that are central to economic growth and development. And this importance of FDI underlines the significance of an appropriate regulatory regime governing this investment.

The rise of FDI was made possible, to a large extent, by an enabling regulatory environment. Especially since the mid-1980s, the investment climate has become more welcoming for foreign direct investors. Countries have liberalised national entry conditions for MNEs, instituted various measures to attract such enterprises actively (for example, through incentives and the establishment of investment promotion agencies), and facilitated the operations of foreign affiliates once established (Table 12.1).[4]

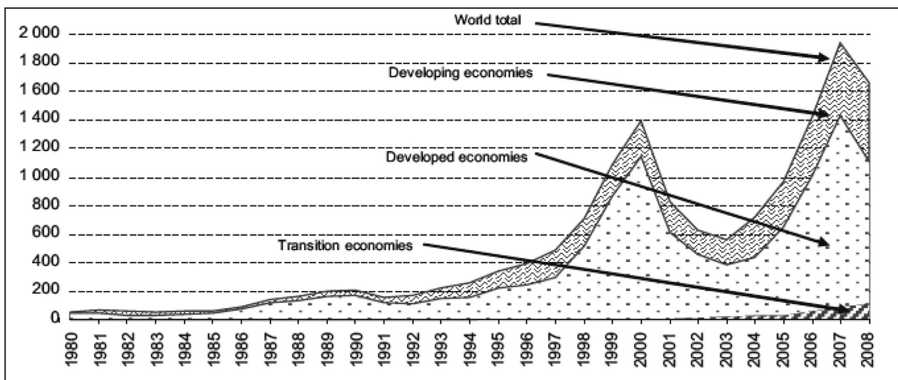

Figure 12.1: *FDI Inflows, Global and by Group of Economies, 1980–2008 ($ billions)*

Source: UNCTAD (2009, 6).

[4] Independent of the changes that countries have made regarding FDI, countries have also improved – and are continuing to do so – the business climate for investment in general (some of these changes may also be captured by the UNCTAD data). Thus, the World Bank observed (*Doing Business 2009* (Washington: The World Bank, 2008, 1). "Worldwide, 113 economies implemented 239 reforms making it easier to do business between June 2007 and June 2008. That is the most reforms recorded in a single year since the *Doing Business* project started. In the past year reformers focused on easing business start-up, lightening the tax burden, simplifying import and export regulation, and improving credit information systems".

These national regulatory changes have been complemented by international investment agreements (IIAs), particularly bilateral investment agreements (BITs), enshrining (among other things) the non-discriminatory protection of investment (Figure 12.2). Increasingly, moreover, commitments for the protection of international investment, and indeed the liberalisation of entry conditions, are also included in free-trade agreements; in fact, the great majority of modern free-trade agreements are also free-investment agreements (Figure 12.3). As a result, and even in the absence of an overarching multilateral investment treaty,[5] a relatively strong international investment regime has emerged, at least as far as the protection of investors is concerned.[6] It is enforced, moreover, through an investor-state dispute settlement mechanism that is increasingly used by firms to protect what they see to be their rights: there were a minimum of 318 known treaty-based international investor-state disputes by the end of 2008,[7] with 30 percent of them brought by investors during 2006–08 (Figure 12.4). For comparison: 91 panel reports were issued under Article XXIII of the GATT between 1948 and 1994, and 161 panels were established by the Dispute Settlement Body under the WTO between the beginning of 1995 and November 24 2008.[8]

Table 12.1: *National Regulatory Changes, 1992–2007*

Item	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Number of countries that introduced change	43	56	49	63	66	76	60	65	70	71	72	82	103	92	91	60
Number of regulatory changes	77	100	110	112	114	150	145	139	150	207	246	242	270	203	177	98
More favourable	77	99	108	106	98	134	136	130	147	193	234	218	234	162	142	74
Less favourable	0	1	2	6	16	16	9	9	3	14	12	24	36	41	35	24

Source: UNCTAD (2008).

[5] There are, however, several multilateral treaties that cover aspects of international investment, most notably the GATS and TRIMs agreements of the WTO, as well as MIGA.

[6] There are a number of limitations to this regime. Among others, some limitations are related to the fact that there is no overarching multilateral framework governing foreign investment (as the regime consists of a great number of international investment agreements that are not identical in their language), some of them are related to the regime's unbalanced nature and some of them are related to the workings of the arbitral system. One of the first to deal with some of these issues was José E. Alvarez (see Alvarez, 1992). See also, Joseph E. Stiglitz (2008); van Harten (2007); Alvarez (2008 and forthcoming); and Sornarajah (2004 and 2008). Of course, there are differences between these various authors. Some call for radical changes, while others focus on specific aspects.

[7] Only ICSID reports the number of cases; hence the actual number of disputes is likely to be higher. The following data are from UNCTAD (2009) (UNCTAD has the most comprehensive database on international investment disputes.) For a discussion of the reasons for this explosion of investment disputes, see Salacuse (2008).

[8] It should be noted, however that disputes in the framework of the GATT/WTO multilateral trading system are State-State disputes.

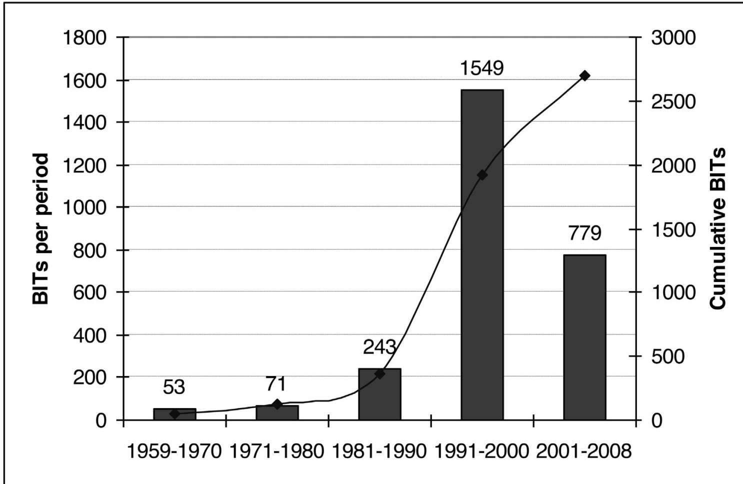

Figure 12.2: *Growth of Bilateral Investment Treaties, 1959–2008, by Period and Cumulative*

Source: UNCTAD, www.unctad.org/iia

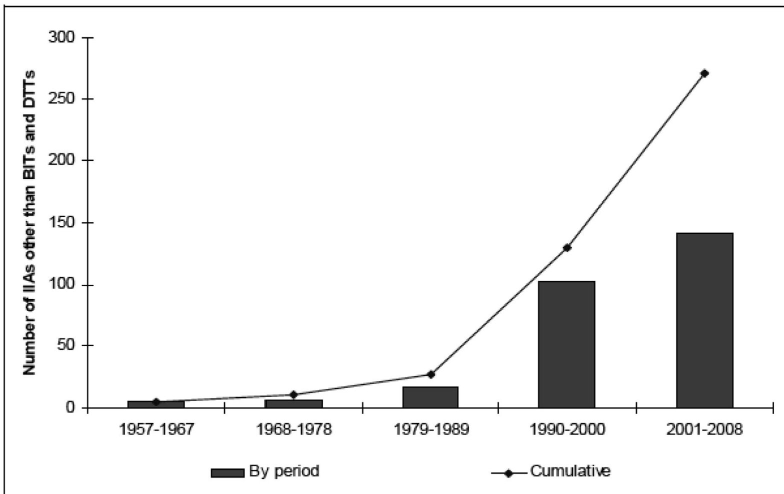

Figure 12.3: *Number of International Investment Agreements other than Bilateral Investment Treaties and Double-taxation Treaties Concluded, Cumulative and per period, End 2008*

Source: UNCTAD (2009c)

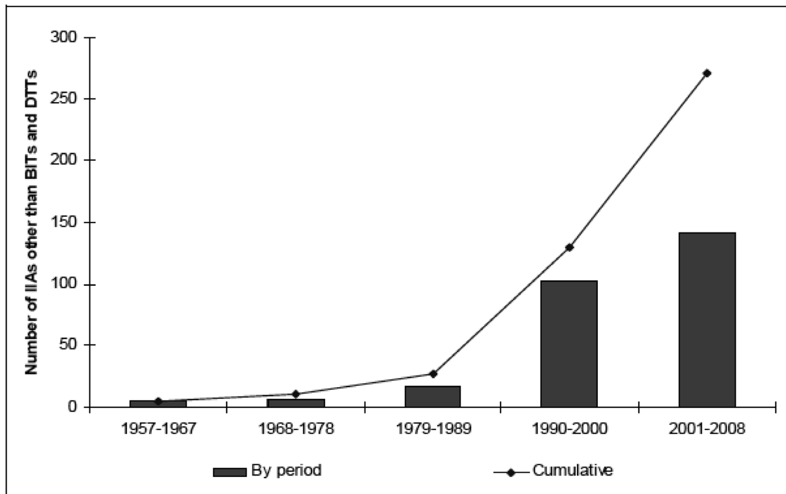

Figure 12.4: *Known Investment Treaty Arbitrations, Cumulative and Newly Instituted Cases, 1989–2008*

Source: UNCTAD (2009b)

2. THE RISE OF FDI PROTECTIONISM

There is no doubt that countries continue to improve the regulatory framework for FDI. If anything, the current crisis should put a premium on attracting more of such investment, be it to shore up ailing national firms or, more generally, to increase investment at a time of recession. Indeed, as reports by the OECD and UNCTAD show,[9] this is taking place. Thus, the OECD reports that the "thrust of investment policy changes is, for the most part, toward greater openness and clarity.... During the reporting period, six countries changed the laws governing their investment policies. Although the intended thrust of the policies is somewhat ambiguous, most of the changes aimed (according to announcements or notifications by governments) at increasing openness and clarity for investors".[10] Similarly, UNCTAD reports, "a substantial number of policy changes surveyed were directed at facilitating investment. The crisis has galvanised G-20 members to promote and facilitate FDI and to create clarity and stability concerning their investment frameworks. Furthermore, a number of G-20 member countries have

[9] OECD (2009a), UNCTAD (2009d). Together with the WTO, these three organisations will issue a joint report in September 2009 reviewing regulatory changes regarding FDI.

[10] OECD (2009), op. cit., 5.

[11] UNCTAD (2009d), op. cit., para. 26.

further encouraged their companies to venture abroad, and to support their foreign affiliates in times of economic crisis".[11]

At the same time, however, there are strong and visible signs that a re-evaluation of the open framework for FDI is under way, and this is reflected in the national and international rules governing this investment.[12] This change is most distinct, so far, at the national level. During the period 1992–2002, six percent of a total of 1550 regulatory changes relating to FDI were in the direction of making the investment climate *less* welcoming (that is, 94 percent of the regulatory changes were favourable to MNEs – Table 12.1). The share of unfavourable changes doubled to 12 percent of all regulatory changes during 2003–4, and again almost doubled to 21 percent of all regulatory changes during 2005–7. In the case of Latin America, some 60 percent of all FDI regulatory changes in 2007 were unfavourable to foreign investors (Figure 12.5). Moreover, these data refer to formal changes in laws and regulations; no data are available on the extent to which unchanged laws and regulations are implemented in a more restrictive manner, increasing informal barriers to the entry and operations of foreign investors in a discriminatory manner.

Overall, countries that had implemented at least one regulatory change that made the investment framework less welcoming during 2006–7 accounted for some 40 percent of world FDI flows[13]—an impressive figure that demonstrates quite convincingly that a change is under way.

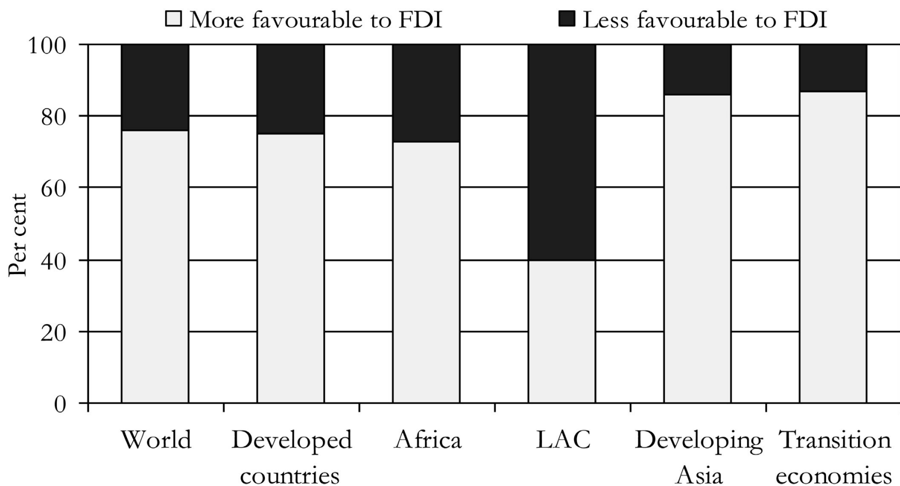

Figure 12.5: *National FDI Policy Changes, by Region, 2007*

Source: Zhan (2008).

[12] For a full discussion, see Sauvant (2009).
[13] Sauvant (2009), op. cit., pp. 239–240.

While it is clear that something is happening, not every measure that makes the investment climate less welcoming for foreign direct investors is protectionist. There are two situations that qualify as FDI protectionism: in the context of inward FDI, FDI protectionism involves new measures by public authorities that are taken to prevent or discourage foreign direct investors from investing in, or staying in, a host country. In the context of outward FDI, FDI protectionism involves measures directed at domestic companies that require them to repatriate assets or operations to the home country, or discourage certain types of new investments abroad. In fact, the situation is more complicated because, for instance, measures taken in the interest of legitimate public-policy objectives – for example, protecting national security, seeking to increase the contribution of FDI to the host or home economy – are not necessarily instances of FDI protectionism, even if they make the investment climate less hospitable for foreign investors.

Even with this caveat, it is clear that the regulatory framework is becoming more restrictive. It predates the current financial crisis and recession, suggesting that a re-evaluation of the costs and benefits of FDI had already been under way. The financial crisis and recession may dampen the rise of FDI protectionism as countries seek capital to shore up local firms and to increase investment to help them emerge from the recession. But the crisis may also accentuate protectionism, especially if nationalistic impulses gain the upper hand, perhaps stimulated by fire sales of domestic assets (as we saw during the Asian financial crisis[14]).

The principal approach that has been taken to make the regulatory framework more restrictive for foreign investors is to evoke 'national interests', 'essential security interests' or similar concepts (often linked to strategic sectors and national champions), to screen foreign investments at the national level. These concepts are typically defined imprecisely, thereby giving governments of host countries discretion to limit the applicability of the regulatory framework and potentially opening the door for discriminatory treatment of foreign investors. This approach also focuses on cross-border mergers and acquisitions (M&As)[15] and pays particular attention to sovereign FDI (that is, FDI undertaken by sovereign wealth funds and state-owned enterprises).

The measures taken by the United States are illustrative. On the one hand, the United States remains one of the most open countries for FDI, as underlined, for example, in the May 2007 statement on 'Open economies' by former President

[14] See Zhan and Ozawa (2001).

[15] M&As account for the bulk of FDI in developed countries and a substantial share of FDI in emerging markets. A 2007 Economist Intelligence Unit survey of 258 senior executives across Asia found that the United States (24 percent), China (23 percent), and France (13 percent) are regarded as the countries most likely to block M&As because of strategic or political considerations. See Norton Rose, *(*2007), p. 4. It would however be wrong to conclude from these data that M&As are typically resisted: the bulk are normal commercial transactions that receive little attention (unless competition issues are involved).

[16] "President Bush's Statement on Open Economies", May 10, 2007, available at: http://www.whitehouse.gov/news/releases/2007/05/20070510-3.html.

George W Bush[16] and the establishment of an 'Invest in America' office in the Department of Commerce. At the same time, though, and especially in the aftermath of 9/11, national security concerns have risen in prominence.[17] For the United States, this concept involves primarily (but not only) military security, namely the protection of the defence industrial base and critical technologies that provide a military advantage, as well as more broadly the protection of assets that constitute critical infrastructure[18] (the damage to which could harm the nation's security). It also includes protection against terrorism concerns and cooperation on important geo-strategic security initiatives, such as non-proliferation.

To clarify the government's authority and the process undertaken to ensure that cross-border M&As[19] do not infringe on national security, the United States in 2007 passed the *Foreign Investment and National Security Act* (FINSA),[20] which codified the role of the Committee on Foreign Investment in the United States (CFIUS) in reviewing the national security implications of cross-border M&As. CFIUS has the authority to review and investigate cross-border M&As and to negotiate, impose, and enforce conditions to mitigate any threat to national security presented by any transaction. If a review takes place, it must be completed within 30 days. If such a review leads to an investigation, it needs to be completed within 45 days. A transaction is to be investigated if any of the following conditions applies: a transaction threatens to impair the national security of the United States, and this threat has not been mitigated during or prior to the review of the transaction; a transaction involves a foreign government-controlled entity; a transaction would result in control of any critical infrastructure and could impair national security; or the lead agency and CFIUS agree that an investigation should take place. If CFIUS recommends action, the President must make a decision within 15 days. As can be seen from these criteria, there is a presumption that any M&A by a foreign sovereign investor (be it a state-owned enterprise or a sovereign wealth fund) reviewed by CFIUS needs to be investigated (unless it is determined at the stage of the review that no national security concerns arise).

Not surprisingly, the number of notifications to CFIUS and the number of in-

[17] To quote the then US Secretary of the Treasury, Henry M. Paulson: "Foreign investment into the United States, especially by sovereign wealth funds and state-owned enterprises, is also increasingly viewed with suspicion by some US companies, various members of the national security community, and the American public at large…." See Paulson (2008), p. 72.

[18] "Critical infrastructure" is described as "systems and assets, whether physical or virtual, so vital to the United States that the incapacity and destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any combination of those matters". In the context of investment, the description refers to "systems and assets, whether physical or virtual, so vital to the United Sates that the incapacity or destruction of such systems and assets would have a debilitating impact on national security". See Department of Homeland Security, "National infrastructure protection plan" (Washington: Department of Homeland Security, 2006), at www.dhs.gov. According to Graham and Marchick (2006), this definition covers industries accounting for approximately 25 percent of the US non-agricultural workforce.

[19] US regulatory changes do not extend to Greenfield investments.

[20] See Fagan (forthcoming). The Department of the Treasury on November 21, 2008 published the final regulations implementing FINSA.

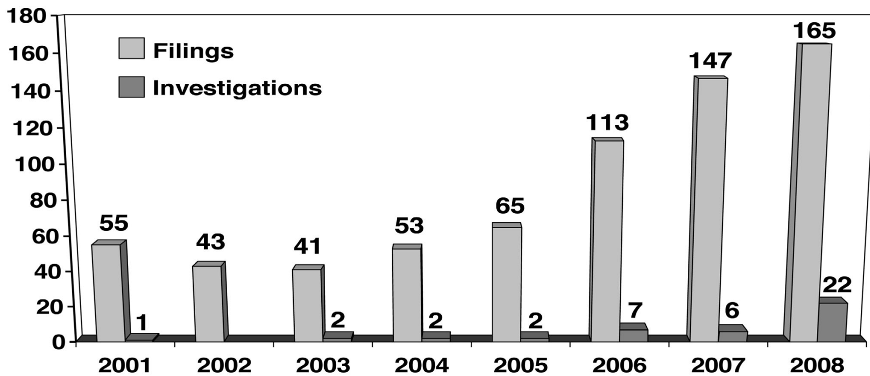

Figure 12.6: *CFIUS Filings and Investigations, 2001-2008*

Source: Data provided by US Treasury Department.

vestigations rose from, respectively, 55 and 1 in 2001 to 165 and 22 in 2008 (Figure 12.6). Data for the first six months of 2009, however, show a decline of notifications to 36[21]– which is apace for 60-70 this year, down from 165 last year; this indicates perhaps the recognition that the country needs, at least in the current economic situation, direct investment from abroad, including from sovereign investors. It is not known how many cross-border M&As that were intended or initiated did not go forward because of the new US regulatory framework.

Other developed countries, too, have put in place mechanisms that allow stricter screening, with concerns regarding national interests often being also of an economic nature. In Europe, both at the national level and at the level of the European Commission, they involve, in particular, sovereign FDI from Russia (and, perhaps in the near future, from China) and, more broadly, the protection of national champions.

Specific national policy responses include:

- **Germany**: A recent amendment to the *Foreign Trade and Payments Act* established a CFIUS-type review mechanism to protect German firms from certain foreign takeovers. Acquisitions by non-EU and non-EFTA firms of 25 percent or more of a German company's voting rights will be reviewed by the govern-

[21] Data provided by US Treasury Department.

[22] *See* http://www.bmwi.de/BMWi/Navigation/Service/gesetze,did=223394.html. Thirteenth Act amending the Foreign Trade and Payments Act and the

Foreign Trade and Payments Regulation, available at: http://www.bmwi.de/BMWi/Redaktion/PDF/Gesetz/englischer-gesetzestext-eines-dreizehnten-gesetzes-zur-aenderung-aussenwirtschaft,property=pdf,bereich=bmwi,sprache=en,rwb=true.pdf.

ment if they threaten 'public security' or 'public order'. This amendment entered into force on April 24 2009.[22] As in the case of the United States, foreign investors can voluntarily pre-notify the Government before an intended acquisition to obtain legal certainty.

- **France**: A decree was issued at the end of 2005 identifying 11 strategic sectors in which investment proposals fall under the purview of the review authorities. In 2008, action was taken to earmark €20 billion for a new state investment fund, among other things, to protect France's strategic industrial assets from foreign takeovers.[2]
- **Australia**: Under the *Foreign Acquisitions and Takeovers Act of 1975*, the Government must determine whether proposed foreign acquisitions are consistent with Australia's national interest (not defined). A new policy was announced on February 17 2008 for proposed investments by sovereign investors. It requires that reviews of applications by such investors consider six specific issues, including whether an investor's operations are independent from the relevant foreign government; the investor's observance of standards of business behaviour; the investment's impact on Australia's national security; and the contribution of an investment to the country's economy and community.[24]
- **Canada**: On March 12 2009, Canada amended its foreign investment law.[25] Apart from changes that liberalised the country's foreign investment review process of general application, the amendment also included a national security test for proposed investments in Canada, which applies to a much broader range of proposed transactions than the pre-existing 'net benefit' test. Now, a proposed investment may be subject to national security review even if it does not exceed the threshold for the net benefit review, whether the investment is proposed or already implemented, and even in cases in which a minority interest is acquired in a Canadian business (that is, where there is no acquisition of control of a Canadian target). As in the case of other countries, there is no definition of what could be 'injurious to national security', and there is a distinct possibility that the test could be used to target certain types of sovereign investment. The details of the national security review process were outlined in draft regulations published on July 11 2009.[26]

[23] Decree No. 2005–1739, JORF no. 304, p. 20779, http://www.legifrance.gouv.fr/. See also "The French investment climate", *American Chamber of Commerce in France* website, http://www.amchamfrance.org/theme1.php?idcontenu=107&idpage=15.

[24] "Government improves transparency of foreign investment screening process", February 17, 2008, available at: http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/009.htm&pageID=003&min=wms&Year=&DocType. An Australian Treasury Media Release (No. 89) of August 4, 2009, entitled "Reforming Australia's foreign investment framework" raised the threshold for a review of private FDI in Australia. As a result, and based on 2008–2009 data, "around 20 per cent of all business applications will no longer be screened by the Foreign Investment Review Board" (ibid).

[25] The amendments are available at: http://www2.parl.gc.ca/HousePublications/Publication.aspx?DocId=3656090&Langu&File=611#194.

[26] Available at: http://www.gazette.gc.ca/rp-pr/p1/2009/2009-07-11/html/reg3-eng.html. See also Bhattacharjee (2009).

- **Japan**: According to its *Foreign Exchange and Foreign Trade Act*, foreign investments that potentially impair national security (not defined), disturb the maintenance of public order, hinder the protection of public safety, or have significant adverse effect on the 'smooth management of the Japanese economy' must be screened by the Ministry of Finance and the Ministry 'having jurisdiction over the business'. The Act was strengthened in 2007 through a regulation that requires foreign investors to notify the Government 30 days in advance if they planned to acquire 10 percent or more of listed companies with technology that can be used in weapons systems.[27]

Additionally, in response to the global financial crisis and recession, several developed countries introduced emergency measures, among other things, to bolster the stability of their financial services sectors and to increase the availability of credit to other parts of their economies. A recent survey of these measures found 'early evidence of differentiation between foreign and domestic actors' in these emergency plans. For instance, the authors of the survey noted that, under the US *Emergency Economic Stabilization Act*, domestic institutions are "the majority if not exclusive recipients of capital injections", and measures taken in the United Kingdom and Germany to promote credit throughout the economy may result in "the provision of credit solely to national industry".[28] It is conceivable that some of these measures will lead to international arbitrations.

A number of emerging markets also seem to be moving into the direction of a more restrictive regime:

- **China**: China strengthened its review system in August 2006, when the Government announced *Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*.[29] The regulation provides that approval is required if a foreign investor obtains actual control over a domestic enterprise if the transaction involves a critical industry, has or may have an impact on the country's national economic security, or would result in the transfer of famous trademarks or traditional Chinese brands (none of these categories is defined). This new screening mechanism was further enhanced in November of that year when the 11th five-year plan of the National Development and Reform Commission responded to "perceived rising concern over foreign acquisitions of

[27] Available at http://www.meti.go.jp/policy/anpo/kanri/top-page/Taro13-foreign-exchange-and-for.pdf. The Act dates to 1949 and regulates foreign transactions; it was amended in 1980 and 1998 to liberalise these transactions. See also *Financial Times,* September 6, 2007. The rules contain a list of 137 products.

[28] van Aaken and Kurtz (2009). The authors observe further (p. 2): "If this trend continues, there may be differentiation against foreign institutions as a matter of fact, even if not on the face of the law".

[29] Provisions of the Ministry of Commerce, State-owned Assets Supervision and Administration Commission of the State Council, the State Administration of Taxation, the State Administration for Industry and Commerce, Securities Regulatory Commission of China and the State Administration of Foreign Exchange on "Mergers and Acquisitions of Domestic Enterprises by Foreign Investors", August 8 2006, at http://www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=66925. The regulation took effect on September 8, 2006. See also China Economic Information Network, *Semi-monthly Business Review*, no. 63, November 28 2006.

leading Chinese firms in critical sectors" by providing for "increased supervision of sensitive acquisitions to ensure what are termed 'critical industries and enterprises' remain under Chinese control".[30] The subsequent anti-monopoly law (which took effect in August 2008) "specifically provides that acquisitions of domestic enterprises by foreign investors that may have implications for national security shall be subject to not only competition review, but also national security review".[31]

- **Russia**: A 2008 law *On Procedures for Foreign Investments in Companies of Strategic Importance for National Defense and Security* requires government approval for certain transactions involving foreign investors if: (i) the Russian company is engaged in an "activity of strategic importance to the country's defense and national security" and (ii) the foreign investor would control either the company or rights to "natural resource deposits having federal importance".[32]
- **India**: The government recently introduced investment policy measures that include a requirement of prior approval for the transfer of ownership or control from resident Indian citizens to non-resident entities in specific sectors, including air transport services, banking, insurance, and telecommunications.[33]

These national actions are supplemented by supranational efforts, although these are voluntary in nature. Thus, the EU Commission has sought to complement the national approaches of members of the European Community, by formulating guiding principles concerning SWFs, supplemented by efforts to increase the transparency of SWFs.[34] The OECD produced guidelines for host country investment policies relating to national security.[35] Based on the principles of liberalisation, non-discrimination, standstill, transparency, proportionality, and accountability, these guidelines underline at the same time the right and duty of host countries to take measures to protect national security. Whether or not a situation involving national security exists is self-judging by the governments

[30] OECD (2008a).

[31] "China finally enacts anti-monopoly law", Freshfields Bruckhaus Deringer Briefing, September 2007, at http://www.freshfields.com/publications/pdfs/2007/sept05/19887.pdf, 4. It appeared in August 2008 that a "Joint Ministerial-level Meeting for the Security Review of Mergers & Acquisitions of Domestic Enterprises by Foreign Investors" was in the process of being established to review M&As having national security implications and, apparently, also to review new FDI projects with national security implications; see Nathan Bush and Zhaofeng Zhou, "Chinese Antitrust – Act II, Scene 1," at http://www.abanet.org/antitrust/at-source/08/10/Oct08-Bush10-24f.pdf, 9. As to the possible interpretation of 'national security', see the following comment by Xu Jialu, Vice-Chairperson of the National People's Congress: "State security includes national defense security, information security, environmental security, and economic security". Ibid.

[32] The text of the law in Russian is available at http://www.rg.ru/2008/05/07/investicii-fz-dok.html.

[33] Press Note No. 3 (February 14, 2009), available at: http://siadipp.nic.in/policy/changes/pn3_2009.pdf.

[34] Council of the European Union, revised version of the Presidency Conclusions of the Brussels European Council, 13/14 March 2008, 7652/1/08 Rev 1, Brussels, May 20, 2008.

[35] "Sovereign Wealth Funds and Recipient Country Policies. Letter transmitting the Report of the OECD Investment Committee to G7 Finance Ministers". The earlier version of the report of the OECD Investment Committee, adopted by it on April 4, 2008, is attached to this letter; it can also be found at http://www.oecd.org/dataoecd/34/9/40408735.pdf

concerned. And the International Working Group of Sovereign Wealth Funds agreed in 2008 on *Generally Accepted Principles and Practices* for SWFs and submitted them to the IMF's International Monetary and Financial Committee;[36] it is expected that observance of these principles by sovereign wealth funds will persuade host country governments not to take restrictive actions.

Several features characterise most of these actions. For one, they seek to balance support for an open investment regime – the dominant approach – with a desire to have sufficient flexibility to stop undesired foreign direct investments, typically involving cross-border M&As. The criterion most often used is, as already noted, 'national security' or related concepts – but, and this is crucial, these concepts are not defined precisely but rather, are left open for definition by national governments. Screening mechanisms have the task of doing that, but their decisions are typically the result of 'black-box' deliberations and often cannot be appealed.[37] While this type of decision-making may work relatively satisfactorily when the screening mechanism consists of representatives of government departments that reflect a plurality of interests, it may work less well when this is not the case, for example, where the executive branch or a representative thereof has the sole discretion to allow or block an investment (that is, an explicit political, as opposed to administrative, process). In either event, moreover, such screening mechanisms, deciding on a case-by-case basis, make the investment climate less predictable and less transparent. However, it is clear that sovereign investors receive special attention, that is, they are treated differently from domestic investors and private foreign direct investors, especially, it appears, when they are headquartered in emerging markets. Among other things, this reflects the fear (for which there is

[36] International Working Group of Sovereign Wealth Funds (IWG), "Sovereign Wealth Funds: Generally Accepted Principles and Practices, 'Santiago Principles'" (Washington, D.C.: IWG, October 2008).

[37] To quote the OECD ("Accountability for security-related investment policies" (Paris: OECD, November 2008), mimeo, 6: "The degree to which individual awards and procedures can be contested in courts or through administrative appeals mechanisms varies across countries. Some countries (for example Argentina, China, France, Germany, Korea, Lithuania, and the United Kingdom) do allow rejected foreign investors to contest the security-related investment policy decisions in various ways. [footnote omitted]WHERE IS THE CLOSING QUOTE MARK?

A separate issue relates to regulatory decisions made based on classified information. The need to safeguard national security may, in this case, militate toward either avoiding legal contestation altogether, curtailing the plaintiff's right to subpoena and examine crucial evidence, or applying specific court procedures – or specialised courts – designed to safeguard the confidentiality of sensitive government information. Similarly, the concerns that motivated a measure may also necessitate withholding information from the investor; thus making legal recourse difficult or impracticable. In addition, some national constitutions, by allocating authority with respect to national security, may place limits on the scope of authority of the courts.

Some countries allow investors to contest regulatory decisions on procedural grounds. "... The coverage of the reviews by the judicial or arbitrational instance differs across countries, as does the extent of possible remedies, but in most cases a victory for the plaintiffs will lead to a renewed regulatory review rather than a reversal of the decisions".

[38] Considerations of this kind may have played a role in the abortive attempt of CNOOC (China) to take over UNOCAL (United States) and Huawei's attempt to acquire a stake in 3Com (United States). In light of the financial crisis and recession, it appears, however, that attitudes toward one class of foreign investors, SWFs, are becoming more welcoming, at least temporarily so. See Fotak and Megginson (2009).

however no systematic evidence) that such investors pursue not only commercial interests but also political interests of the governments involved.[38]

While governments need, of course, the flexibility to pursue legitimate public policy objectives (be it national security, economic development, or any other critical objective) and may have introduced regulatory provisions and mechanisms in good faith (namely to protect critical interests), the boundary line between protecting legitimate public policy objectives and protectionism is a fine one and, for that matter, not always easy to determine. The fuzziness of the key concepts involved inevitably creates the risk of abuse for protectionist purposes. This makes it all the more important to watch these new regulatory developments closely, especially since the rules that have been put in place leave considerable discretion to national policy makers, and their decisions often cannot be appealed. In fact, that governments think that it is necessary to put in place screening mechanisms suggests that their strong welcoming attitude of the past toward FDI is giving way to a certain caution (or at least to a more considered approach) concerning such investment. Moreover, what is worrying is that developed countries are leading this change in approach, that is, countries that had been, in the past, the champions of the liberalisation of entry and operational conditions for foreign investors and the protection of investments under international law. If developed countries change their attitude toward FDI, this is likely to have a demonstration effect for emerging markets, leading the latter possibly also in the direction of protectionist measures.

It needs to be pointed out that governments recognise that investment protectionism is on the rise. In particular, the G20 (in its *communiqués* issued in November 2008 and April 2009) called for a moratorium on new investment protectionist measures.[39] In its April 2009 declaration, it furthermore asked "the WTO, together with other international bodies, within their respective mandates, to monitor and report publicly on [the G20 members'] adherence to these undertakings"; the urgency of this matter is underlined by the fact that the G20 leaders requested that this reporting take place "on a quarterly basis".[40] It was further reaffirmed by the G8 in their July 2009 declaration when that group observed:

[39] See, Group of 20, "Declaration: Summit on Financial Markets and the World Economy," November 15, 2008 (available at http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html). It said in the first paragraph of para. 13: "13. We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services...". This call for a moratorium was repeated in Group of 20, "The global plan for recovery and reform", April 2 2009 available at http://www.g20.org/Documents/final-communique.pdf. In paragraph 22, the G20 leaders reiterated: "We will not repeat the historic mistakes of protectionism in previous eras. To this end, we reaffirm the commitment made in Washington: to refrain from raising new barriers to investment or to trade in goods and services.... In addition we will rectify promptly any such measures. We extend this pledge to the end of 2010...".

[40] Ibid., para. 22.

"We will work to reverse the recent decline in FDI, by fostering an open, receptive climate for foreign investment, especially in emerging and in developing countries".[41] In its first document issued in response to the G20 reporting request, then, UNCTAD observed that "[o]verall, ... investment policy developments paint a comforting picture", but it also warned "there is no room for complacency. Indeed, a number of areas exist where caution in terms of protectionist dangers and investment distortions appears warranted".[42] UNCTAD drew particular attention to what it labels "'smart' protectionism",[43] in which, for example, a government takes advantage of gaps in investment regulations to discriminate against foreign investors.

3. CHANGES IN THE INTERNATIONAL INVESTMENT REGIME

The changes at the national level are also leading to changes in the nature of the present international investment regime, for instance in the bilateral investment treaties that make up a substantial part of the regime. As already mentioned, at the core of this regime is the protection of foreign investors, based on the principle of non-discrimination of foreign investors, (and, if discrimination takes place, the obligation to compensate investors). The changes that are under way in the international investment regime reflect those in process at the national level, by giving governments more flexibility to pursue national policies *vis-à-vis* FDI.

Most indicative in this respect is the United States' model bilateral investment treaty of 2004, if compared with the 1984 model.[44] It weakens various protections that international investors had acquired through BITs and free trade and investment agreements and hence gives more rights to governments. In particular, it explicitly includes an 'essential security' clause that is self-judging. In other words, the treaty partners decide on their own, and not subject to arbitral review, whether or not a given situation involves an essential security interest and therefore makes it unnecessary to observe commitments contained in a given treaty.

Such an evolution of the international investment regime is understandable, given that governments seek more freedom to pursue what they consider to be important national objectives, and given that they do not want to be penalised

[41] See, G8 Leaders Declaration, "Responsible leadership for a sustainable future", July 8 2009, para. 49. In para. 50 (still in the Declaration's Investment section) the leaders affirm: "Aware of the global nature of the markets where our citizens and businesses operate, and of the international effects of our actions, we fully stress our engagement against protectionist measures. In this light, we welcome OECD's efforts to monitor restrictions on investments and encourage the ongoing joint work of the OECD Freedom of Investment Roundtable (FOI RT) with the WTO, the United Nations Conference on Trade and Development (UNCTAD) and the IMF, in this area".

[42] UNCTAD (2009d), paras. 25 and 27. UNCTAD also warns "there is a need to ensure that current endeavours against investment protectionism do not remain one-off initiatives". Ibid., para. 28.

[43] bid., para. 27.

[44] See Vandevelde (2009) and, even stronger, Alvarez (2004). The 2004 US model BIT was under review beginning in 2009; it may well be that the outcome is a further strengthening of the rights of host country governments.

(through arbitral awards against them) for actions taken in this respect. But this greater respect for national policy priorities is also understandable from another perspective: the international investment regime as it has evolved over time has focused almost exclusively on the protection of international investors by granting them broad rights and few responsibilities, while host country governments assume broad responsibilities and have few rights.[45]

4. THE NEED FOR REBALANCING

The critical challenge therefore is to find the right balance between the rights and responsibilities of foreign investors on the one hand and those of governments on the other. It needs to be a balance that combines the stability, predictability, and transparency that firms need to make investment decisions with the policy space that governments need to pursue legitimate domestic policy objectives – a balance that does not open the door for measures that are primarily protectionist in nature.

Finding regulatory solutions to this challenge is not easy. It is important that the process of rebalancing, which is already under way, proceeds in a manner that strengthens the overall international investment regime. Among other things, this requires a clarification of such concepts as 'national interest'[46] and 'essential security interests', as well as concepts such as 'critical infrastructure'[47] and 'strategic sectors', with a view toward arriving at an international consensus as to what these concepts encompass. If such a clarification process of a number of key concepts can be undertaken in an international organisation, which would be desirable, if involving as many countries as possible.[48] There is, of course, the risk that such an intergovernmental approach could become politicised, with countries merely restating their respective positions; still, it would be an important and desirable step forward.

A more ambitious approach would be to convene an international group of non-governmental experts from all regions of the world to arrive at something akin to the US policy restatements.[49] A '*Restatement of International Investment*

[45] The underlying logic for favouring protection of investors over preserving host country policy space is, among other things, which MNEs are, in any event, subject to the laws and regulations of host countries that can be enforced through national courts and that such a regime helps countries to attract FDI. For evidence regarding the latter expectation, see Sauvant Lisa Sachs, eds. (2009).

[46] A survey by the OECD of a number of countries and their use of the concepts of 'national security', 'essential security interests' and 'public order' found that "the term 'national security' is shown to have a coherent and internationally understood meaning". (See OECD, 2009b). If this finding regarding 'national security' does, indeed, hold for a great number of countries, applies also to related concepts such as 'public order' and 'essential security interests' and is supported by arbitral decisions, then this would indicate an emerging consensus in this area.

[47] See in this context OECD (2008b).

[48] See in this context some of the publications prepared by the OECD Secretariat and referred to elsewhere in this chapter.

[49] The two approaches – an intergovernmental process and a process presumably involving primarily academic experts – are not mutually exclusive.

Law' would show where there is convergence in the provisions of IIAs, including in terms of the rights and responsibilities of investors and states and the definitions of often-used terms-of-art in the IIAs. Even if consensus were found on aspects of international investment law, this does not mean that all governments would necessarily adopt those terms or definitions in the agreements they negotiate; in fact, they may deliberately want to leave certain terms (like 'national security') vague, to allow themselves flexibility for their national policies. For concepts and terms that still vary widely among IIAs, the Restatement could present alternative interpretations side-by-side, with explanations and commentary where possible. It is conceivable that indicating where the law continues to diverge and helping to explain the rationale could be a boost toward the harmonisation of international investment law. And at the least, such a restatement that clarified terms and outlined differences would be a valuable resource for investors and countries alike to understand better the complex investment-law landscape, and a useful guide for arbitrators and negotiators of investment agreements.

Ultimately, however, a multilateral framework for investment is required to marshal the full strength of universal and consistent rules in this area, complemented by a functioning dispute-settlement mechanism. As we know from the experience in the United Nations, OECD, and WTO, the creation of a multilateral framework for investment is a very difficult task indeed, and one that – if pursued at all in the foreseeable future – will take considerable time.[50] Still, a clear and consistent multilateral framework – reflecting in a balanced manner the rights and responsibilities of investors and governments – would provide the most credible and coherent parameters for investment policy-making at the national level. And as national policies are as important in the international investment law regime as international agreements and treaties, a multilateral effort to define the parameters of such national policy-making would strengthen the overall regime significantly. While a multilateral investment agreement would be the most powerful instrument to guide national policy-making, even a restatement, as discussed above, that illustrated areas of consensus and areas of weakness in the investment regime would help set useful parameters.

In the meantime, however, policy-making at the national level will continue to evolve on its own. It is clear from the foregoing discussion that a number of governments have put mechanisms in place that allow them, if need arises, to screen

[50] Although, as the IMF SWF Principles show, rules can be formulated quite rapidly if important countries desire to do so. It is interesting to note in this context that the G8, in its July 8 2009 communiqué, noted: "... we commit to enhance cooperation with our major partners to agree upon shared principles which may serve as the basis for a more structured and wider process towards an agreed common multilateral framework in the long run creating a predictable and stable climate for investment. To this end, we commit to work with our HDP/HAP [Heiligendamm Dialogue Process/Heiligendamm L'Aquila Process] partners to produce in one year's time a report on progress made in order to evaluate possible common responses, including the feasibility of launching a process with wide ownership, and with participation from relevant international organisations such as OECD, UNCTAD, the World Bank, and other major stakeholders". G-8 Leaders Declaration, "Responsible leadership for a sustainable future", July 8, 2009, para. 52.

out specific FDI projects that, in their opinion, are not desirable. To what extent they will actually use these mechanisms only for the limited purpose of protecting legitimate national objectives – or, rather, will abuse them for protectionist purposes – is a matter for watchful waiting. International exhortations urging governments not to introduce FDI protectionist measures are of course important and need to be reiterated. At the same time, though, it would be highly desirable if watchful waiting and international exhortations were complemented by an independent FDI Protectionism Observatory to monitor new FDI protectionist measures and 'name and shame' the countries that take them.[51]

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[51] OECD, UNCTAD and the WTO monitor changes in investment laws regardless of the direction in which they go (see the earlier references). The secretariats of international organisations have, however, the problem of pronouncing themselves about the nature of policy changes introduced by individual members, as their members will tend to resist that their actions are labelled 'protectionist'; rather, members may prefer that these measures are characterised as 'clarifications' and the like – which, in some cases, they may well be. It is in fact not always easy to determine whether a given measure is protectionist, intended or not; hence the task of such an Observatory (were it to be established) would need to be carried out in a very careful manner.

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13

Responses to the Economic and Financial Crisis: Whither Competition?

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1. INTRODUCTION

In order to contain the damage done by the financial and economic crisis and to prevent the occurrence of new crises, governments are under strong pressure to intervene in the financial sector and in the real sector.

In the financial sector, the interconnection between banks and financial institutions and the fact that this sector operates on trust means that a bank run could contaminate the entire sector and lead to a systemic failure, which would bring the economy to a standstill. Governments are eager to intervene to ensure the stability of the financial system.

In the real sector of the economy, governments are also under strong pressure to intervene, not because of the possibility of a systemic failure, but to alleviate the effects of the economic downturn. Governments are expected to take whatever measures are necessary to revive demand, to stimulate supply, to prevent the possible bankruptcy of firms hit by the hard economic conditions and to stem the growth of unemployment. Additionally, the current crisis has made a large number of people in developed countries more aware of the importance of the personal costs they have to bear in an economic downturn, and they realise that such a downturn can be the result of factors over which neither they, nor their employers, have any control. Hence, it is likely that voters have become more risk averse than they were before the crisis occurred and that there is high social demand for government measures designed to protect them from market forces (including domestic and foreign competition). This trend is dramatically illustrated in a recent survey in Germany by Ernst and Young, which found that 78 percent of small and medium-size companies favour the state embracing 'protectionist measures' to shield them from the global recession, as compared to 43 percent a year ago[2]. Thus,

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[2] See "Protectionism on the Rise in Europe?" *Time*, Wednesday February 4 2009.

since the beginning of the financial and economic crisis, a large number of measures designed to shore up the financial sector, to provide assistance to businesses, to restructure industries, or to protect domestic producers have been adopted in many countries.

In this context, and from a policy perspective we will address three questions. First, what kind of measures potentially harmful to competition and trade are governments considering or already implementing, and do we have evidence as to the importance of the harm that they could entail? Second, to what extent should competitive concern regarding such measures be taken into consideration when they are adopted? Finally, what recommendations or good practices can governments follow to minimise (or eliminate) the toxic effects on competition and trade of measures designed to contain the current crisis or prevent its recurrence?

2. MEASURES ADOPTED ADOPTED BY GOVERNMENTS IN A PERIOD OF CRISIS

Government interventions either to contain the crisis or to prevent the occurrence of a new crisis are varied, substantial and, as we shall argue, a number of these interventions, whether in the financial sector or in the real sector of the economy, entail serious risks of an anticompetitive effect.

Measures taken by governments can be divided between those aimed at shoring up the financial sector and ensuring the stability of financial markets, and measures aimed at addressing the effects of the economic downturn on the real economy. These measures can be either included in comprehensive schemes at the national level, or implemented independently from such comprehensive schemes when the type of intervention required does not fit a general model.

2.1 Measures aimed at restoring confidence in financial markets and ensuring the stability of financial markets

The aim of such measures is to lessen the impact of the crisis by injecting liquidities in the financial sector, to offer reassurance that weak banks, or financial institutions, will not fail; to restructure the banking sector; to restore the efficient functioning of the credit market.

These measures include:

- Injections of large amounts of liquidity into financial markets by central banks;
- Guarantee schemes covering new issuances of short and medium-term debt to assist banks, credit institutions, pension funds, or insurance companies unable to access interbank funding to overcome a temporary liquidity shortage;
- Explicit government guarantee of financial institutions' liabilities to restore confidence in the banks;
- Regulatory capital forbearance, which allows banks to overstate their equity capital to avoid the costs of contractions in loan supply;

- Recapitalisation measures for banks and insurance companies. The nature, scope, and conditions of recapitalisation schemes vary considerably. Banks can be recapitalised through government bonds, subordinated debt, preferred shares, purchases of bad loans, credit lines, assumption of bank liabilities, ordinary shares, or cash[3];
- Carving-out of insolvent banks' bad loan portfolios (usually accompanied by organisational restructuring of the banks);
- Restructuring of the banking and financial sector to increase the stability of these sectors. There have been many examples of such restructuring such as those of Bear Stearns, Morgan Stanley, Northern Rock, Fortis, ING, IKB, West LB, and Hypo Real Estate, to mention a few.

Some of these measures can distort incentives and have potential anticompetitive effects both on domestic markets in the country implementing them, and internationally.

The Irish experience offers a good example of the way in which a bank guarantee scheme can be discriminatory and trade-distorting as well as competition-distorting. On 2 October 2008, following a crash in the value of bank stocks on the Irish stock exchange, Ireland's finance minister announced that the Irish Government had decided to grant a sweeping unlimited guarantee on all bank deposits at its six main banks for the next two years to maintain financial stability. The potential value of this insurance amounted to €400 billion insurance ($560 billion). The Irish Government did not propose to underwrite the non-Irish banks which were competing with the Irish Banks, thus creating a potential domestic competition problem[4]. Furthermore, the announcement of the guarantee for Irish banks triggered a cross-border flow of cash from British businesses to Irish banks, and the value of the stocks of those banks increased considerably. This cross-border movement made the British banks more fragile and drew an angry reaction from the British government who called on the Irish government "to look quite closely at the arrangements they are putting in place to make sure they comply with EU competition law". The British government rightfully denounced the discriminatory and anti-competitive nature of the Irish scheme. Under the pressure of the European Commission, the Irish government was forced to amend its scheme and to provide for the non-discriminatory coverage of banks with systemic relevance to the Irish economy (not just 'Irish' banks), to bring it into line

[3] The European Commission indicated on 8 April 2009 that since the beginning of the crisis it had authorised State Aid to the European financial sector for a maximum amount of €3000 billion. A large part of this amount (€2300 billion) of State Aid was in the form of state guarantees of the liabilities of banks which Member States would have to pay only if the banks failed. Another €300 billion of State Aid authorised by the European Commission was for recapitalisation of financial institutions and €400 billion of State Aid authorised was for the restructuration of the financial sector. In the United States, as of January 2009, capital injected in recapitalisation schemes amounted to $ 265 billion.

[4] The Irish guarantee scheme can be contrasted with the Slovenian guarantee scheme which was adopted in December 2008. The Slovenian Guarantee scheme (with a capped value of €12 billion) is available to all solvent Slovenian credit institutions, including Slovenian subsidiaries of foreign banks.

with European law. On 13 October 2008, the European Commission approved the amended Irish government scheme to guarantee deposits and debt to eligible banks active in the Irish market.

If we now move to recapitalisation schemes, the UK experience with Northern Rock shows that such schemes also have the potential to disrupt competition. In August 2007, Northern Rock plc. experienced extreme funding difficulties as a result of a liquidity shortage in wholesale money markets. The British Government granted various public support mechanisms to Northern Rock and the bank was taken into temporary public ownership (TPO) in February 2008. At the time, Northern Rock was the only bank in the United Kingdom receiving public support and, as a result, there were concerns about the impact its public support could have on competition in the banking market. The Office of Fair Trading[5] pointed out that in the personal, current account, savings, and investment product markets elements of public support such as TPO and deposit guarantees might create a perception among consumers that Northern Rock was 'safer' than other banks. As a result, consumers concerned about the stability of banks might choose Northern Rock because it was the only bank with a 100 percent deposit guarantee. Northern Rock might therefore be in a position to expand its market share. In a market characterised by natural customer inertia, consumers might not switch back to other banks offering better rates, and the anticompetitive effect of the TPO might extend to the long term.

A second concern expressed by the OFT was that Northern Rock might be able to take advantage of a lower cost of capital in money markets to offer lower rates on its mortgages. As the OFT explained: "If Northern Rock's rivals were, or still are, unable to access capital at equivalent costs for the sole reason that they did not receive public support, then this distortion may allow Northern Rock to expand its market share. This could lead to an adverse impact on competition that may in turn lead to consumer harm. When public support is withdrawn, and the cost of capital rises, it will be unlikely that such attractive mortgage rates will still be made available by Northern Rock. Consumers may not switch to take advantage of other suppliers and so will end up paying more". The competitive risk associated with the government takeover of Northern Rock was not lost on its competitors or the press. "Banks protest at Northern Rock's unfair advantage", reported the *Evening Standard* in February. "Northern Rock rivals complain of unfair competition", said *The Times* one month later. "Northern Rock cuts mortgage rates as rivals go up," reported the *Daily Mail*. "(…) with interbank lending once again ground to a halt but with the full weight of tax-payers' funds stood behind them – what's to stop Fannie, Freddie, Northern Rock and all the other government-owned lenders from dominating their markets…pumping out tax-funded loans at politically-friendly rates of interest?" asked another commentator. To alleviate those concerns, the Northern Rock Restructuring Plan issued in March 2008 included a chapter on 'Working within the Competitive Framework', which

[5] "Northern Rock: The Impact of Public Support on Competition", Office of Fair Trading, March 2009.

stated that Northern Rock recognised the responsibilities it had during the state-aid period and the need to avoid competitive distortions in the markets in which it operated. The restructuring plan included a number of commitments by Northern Rock designed to minimise the risk of competitive distortion. In particular, Northern Rock committed itself not to promote their offering on the basis of Government guarantee arrangements, not to sustain a prolonged market leadership in any product category, and to maintain market shares at well below historic levels. The sheer existence of such commitments, and the fact that they required an elaborate monitoring system (originally the OFT was to report annually on the competitive implications of public support for Northern Rock), is a testimony to the difficulties for the competitive process associated with bailouts of failing banks. It is only through commitments by bailed-out banks that they will not compete, or develop their market shares, that one can hope to counteract the effects of state intervention; but those commitments are at least difficult to design and risk decreasing competition on the market rather than maintaining it.[6]

It has been reported (Davis and Hilsenrath, 2009) that in US insurance, some large insurers such as Lincoln National Corp and Genworth Financial tried to buy small savings and loan associations in Indiana and Minnesota, hoping to qualify as banks and thus become eligible for bailout funds. Only some succeeded. MetLife Inc., which entered the crisis stronger than many rivals, ramped up its borrowing from the Federal Home Loan Bank of New York and had access to Treasury funds. Genworth failed to get regulation approval to buy a thrift and to obtain Treasury funds.

Bank mergers may also have the potential to restrict competition. This can be illustrated again by the British experience.

To put into perspective the events of September 2008 regarding the UK government-engineered acquisition of HBOS Plc. by Lloyds TSB for £12.2 billion ($17.8 billion), it is worth recalling that in 2001 Lloyds TSB had considered buying Abbey National. At the time this merger was prohibited by the UK Competition Commission, on the grounds that it would have led to a substantial lessening of competition on retail markets for personal customers and SMEs. The Lloyds TSB/Abbey National merger would have resulted in Lloyds TSB having a share of around 27 percent on the market for personal accounts. The collective share of the big four UK banks would have risen from 72 to 77 percent, and according to the Competition Commission, the concentrated market structure, combined

[6] In the case of Northern Rock, the OFT published a monitoring report in 2009. With regard to the personal current accounts savings and investment product markets, the OFT while noting the fact that the market share of Northern Rock was minimal on these markets also found that any adverse impacts on competition arising from changed consumer perceptions caused by public support were likely to be minimal. In the mortgage market, the OFT considered that it was unlikely that Northern Rock would be able to use public support as a means to access funding at rates likely to distort competition in the mortgage market.

An important element noted by the OFT in its report was that a number of circumstances which occurred after the Northern Rock restructuring plan was adopted may have lessened the potential anti-competitive impact of the Northern Rock bail out, such as the fact that public support was eventually granted to a number of other banks, the fact that the British Government announced a number of measures designed to increase the funding available to SMEs and to support the mortgage market.

with the fact that entry was considered unlikely, would have facilitated tacit collusion among the big four. In September 2008, HBOS and Lloyds TSB announced their merger plans. On 24 October 2008, the Office of Fair Trading issued a report on the merger. The report stated that the merger between HBOS and Lloyds TSB would lead to Lloyds TSB having a share of around 33 percent of the market for personal accounts and 28 percent of the UK home-loan market; the collective share of the big four UK banks would rise from 67 to 80 percent. Thus, from a structural point of view, the merger between HBOS and Lloyds TSB would lead to a higher level of concentration in the market for personal accounts than what the merger proposed in 2001 between Lloyds TSB and Abbey National would have led to, had it been authorised.

Unsurprisingly, the *Office of Fair Trading Report* on the Lloyds TSB/HBOS Plc.[7] proposed merger stated that: "there is a realistic prospect that the anticipated merger will result in a substantial lessening of competition in relation to personal current accounts, banking services for small and medium-sized enterprises and mortgages". The OFT was also concerned by the size and behaviour of the post-merger combined business, and by the loss of HBOS as a leading challenger to the four established retail banks. The Office of Fair trading examined the question of whether 'the failing firm defence' applied to the case. The OFT considered that the defence was not available: "it is not realistic to consider that HBOS would have been allowed to fail (or that its assets would have been allowed to exit the market". The OFT, suggested an alternative solution which would be less threatening for competition. HBOS could remain independent with some government support, and in the longer term either be sold to a third party with no competition issues, or be returned to independent operation. Given the competitive risks associated with the merger, the Office of Fair Trading recommended to the Secretary of State that the merger should be sent for review to the Competition Commission.

The British Government was determined to see the merger through, but none of the public interest grounds which allowed the Secretary of State to ignore the opinion of the Office of Fair Trading and allow the merger to go through, without referring it to the Competition Commission, was applicable to the case. In order to achieve its goal, the UK government then decided to change the applicable law. On 24 October 2008, the same day that the OFT published its report, an amendment to the UK's merger control rules came into effect. It introduced a new public interest consideration to be weighed against the consideration of effect on competition: 'maintaining the stability of the UK financial system'. On 31 October the Secretary of State swept aside competition concerns and cleared the transaction on financial stability grounds.

2.2 Extending the reach of regulation in the financial sector

There is a natural tendency for governments to extend the reach of regulation to insure themselves against a recurrence of a crisis. It seems intuitively obvious to

[7] OFT, Report to the Secretary of State for Business Enterprise and Regulatory Reform on the Anticipated Acquisition by Lloyds TSB plc. of HBOS plc., 24 October 2008.

risk averse policy makers that, had the financial sector been better and more comprehensively regulated, the financial crisis and therefore the subsequent economic crisis would have been avoided.

Not only is regulation seen as a guarantee for stability in the future, but it is also seen as a necessity to restore confidence in financial markets, and a necessary condition to put economies back on a growth trend. There is a widespread opinion that the crisis has shown that during the 1990s standing rules and regulations governing financial markets did not keep pace with major developments in financial markets. Whereas the development of new instruments and innovation in financial markets is seen as a positive development, it is also retrospectively clear that there were insufficient independent verifications of the risks associated with these instruments.

Calls for more regulation have been heard in a number of areas. For example, some have suggested that banking should be regulated with a view to preventing banks from being simultaneously present in different lines of business (such as commercial banking, investment banking, asset management, and insurance). One rationale for such a proposal is that these different activities have different risk profiles and require different prudential ratios, and that when a bank is engaged in a variety of such activities, there is a possibility that it will use assets coming from operations requiring the lowest prudential ratio to finance its riskier activities. Another rationale is to prevent excessive concentration in the banking sector. For example, in March 2009, when Joseph Stiglitz, Chair of the Commission of Experts on Reforms of the International Monetary and Financial System convened by the President of the United Nations General Assembly, presented the conclusions of the commission, he observed that the focus on inflation had prevented a sustained consideration of the underlying problems of financial stability and that regulatory problems had compounded that situation. Insufficient regulation had allowed banks to grow so large that they were deemed 'too big to fail'. Stiglitz concluded that market economies worked when effective competition existed, but that when there was a failure in competition, as in the case of mammoth banks, they broke.

Along those lines, Switzerland's central bank announced on June 18, 2009 that the Swiss authorities were examining the enforced shrinkage of banking groups such as UBS and Credit Suisse to contain the risk posed by their size, unless global policy makers could come up with a new system to deal with large banks when they fail (Hughes and Jenkins, 2009). The Vice-chairman of the Swiss National bank was reported to have said: "There are advantages to size…[but] in the case of large international banks, the empirical evidence would seem to suggest that these institutions have long exceeded the size needed to make full use of these advantages"[8]. Although no details were given on the mechanism considered by

[8] In 2008, the collective assets of UBS and Credit Swiss were equivalent to six times the Swiss GDP. Their assets represented 73 percent of the Swiss banking system's assets. UBS, hit by bad investments linked to the US mortgage market, has received a government bailout. Credit Suisse has experienced losses but was able to recapitalise privately.

the Swiss authorities, it was reported that the idea being looked at involved limits on the absolute size of balance sheets, or discouraging growth into risky areas by raising capital requirements. Either one of these solutions would clearly have the potential to limit competition in some segments of the banking sector.

In the United Kingdom, Mervyn King, Governor of the Bank of England, has strongly urged that the casino element of the banking system be separated from the conventional borrowing and lending business that enjoys the benefit of deposit insurance and the Bank's support as a lender of last resort (Plender, 2009). Others, such as Lord Turner, Head of the United Kingdom Financial Services Authority, disagree, arguing that: "Serving the financial needs of today's complex globally interconnected economy...requires the existence of large complex banking institutions providing financial risk management products which can only be delivered off the platform of extensive market-making activities, which inevitably involve at least some position taking".

With respect to the scope of regulation, there have been proposals to regulate hedge funds, in particular, to force them to be more transparent regarding their financial structure and the financial links that they have with regulated entities. It has also been suggested that they should be subject to prudential constraints as banks are[9].

With regard to financial instruments, it has been suggested that CDOs should fall within the purview of banking regulation; that limits should be imposed on the securitisation of mortgages; that the recourse to off-balance instruments to hide risky assets should be limited; and that accounting rules for banking assets should be changed to avoid the pro-cyclical effect of the mark to market rules.

It has also been proposed that the financial incentives of bank managers and traders (such as bonuses and stock options) should be regulated. It is clear that problems of corporate governance that had been recognised early in the decade during the Enron and WorldCom scandals have not been appropriately addressed. According to some observers, there is a need to link better the rewards of managers with long-term rather than short-term performances of banks. Finally, it has also been suggested that credit-rating agencies which rate the credit worthiness of their clients, and combine credit-rating activity with consultancy, should be regulated, or that public credit-rating agencies independent of the rated firms should be created.

The G20 *communiqué* of the London Summit reflects the move toward extending regulation in the financial market. The G20 Member States agreed, among other things: "to extend regulation and oversight to all systemically important financial institutions, instruments and markets (including systemically important hedge funds), to endorse and implement...tough new principles on pay and compensation and to support sustainable compensation schemes and the corporate social responsibility of all firms". They also agreed to: "prevent excessive leverage

[9] Some commentators, however, have argued that hedge funds, which pulled securities and funds from their brokers when they realised the banks were funded through lower quality assets, rubber stamped with generous credit ratings, should not be blamed by the crisis but that banks which allowed this situation to develop bore sole responsibility. See for example Michael McKenzie, "It's is a Stretch to Blame Hedge Funds for Banks' Collapse, *Financial Times*, June 27/28, 2009.

and require buffers of resources to be built up in good times" and "to call on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards" and "to extend regulatory oversight and registration to Credit Rating Agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest".

On June 17 2009, President Obama, noting that "unfortunately the growth of the non-bank (financial) sector as well as the complexities and financial instruments outstripped those old regulatory regimes", unveiled a series of sweeping proposals for regulatory changes in the US financial sector. The goal of the US proposal was, in the words of President Obama, to promote "a system that works for business and consumers", one that will enhance "honest, vigorous competition" rather than reward gimmickry[10]. An 'oversight council' would be established to fill regulatory gaps and monitor the overall stability of the financial system; all hedge funds advisers would be required to register with the Securities and Exchange Commission and open their books to regulators; the Commodity Futures Trading Commission and the SEC would have more authority to regulate derivatives, including credit default swaps; there would be an increased capital requirement for all financial institutions; companies that issue mortgages would be required to retain at least 5 percent on their books to discourage companies from marketing unsuitable loans; the plan also called for new 'conflict of interest' rules on credit rating agencies. Finally regulators would issue new guidelines on executive compensation.

All these proposed regulations may have anti-competitive effects and, if they are not well-designed, such effects may go beyond what is strictly necessary to achieve their prudential goals. For example, regulation designed to separate commercial banking and investment banking may have the effect of limiting structural competition between banks. Regulations designed to alter the valuation methods of bank assets will necessarily have an effect on the ability of individual banks to extend credit, and therefore on the level of competition on the credit market. In the United States, the banking industry alleges that the proposed regulation of financial products offered to consumers may stifle innovation and make loans more expensive.

The examination of the proposals to regulate credit-rating agencies (CRAs) also illustrates the potential risks of such proposals on competition in the credit-rating market. Initiatives by regulators and legislative bodies to scrutinise the functioning of CRAs were prompted, before the start of the financial crisis, on both sides of the Atlantic, by such accounting scandals as those of Enron, Worldcom and Parmalat – companies that were still rated 'investment grade' a few days before they filed for bankruptcy. The massive failure of risk appraisal of assets and firms which led to the financial crisis only increased the urge to improve regulation of CRAs (Champsaur, 2005).

[10] "Obama Plan Seeks to Curb Financial Gimmickry", *International Herald Tribune*, June 18, 2009.

Credit ratings help lenders allocate capital to creditworthy borrowers and investors for them to invest in instruments of credit worthy firms. But security and banking regulators have also relied on credit ratings. For example, in June 1999 the Basel Committee proposed a revised capital adequacy accord, finalised in June 2004 (the 'Basel II Agreement'), which provides that banks have the option of relying on ratings provided by CRAs to assess counterparty credit risk, for the purpose of calculating their capital requirements. The US SEC also relies on CRA assessments of the riskiness of assets of the financial institutions it regulates.

The inaccuracy of credit ratings could distort incentives, cost structures, and competition. If banks are able to use credit ratings to calculate capital requirements (as under the Basel II rules), they have an incentive to select highly rated borrowers, since doing so mechanically lowers their capital requirements. If credit ratings do not adequately reflect credit risk, the bank's capital structure might give the illusory impression that it constitutes a sufficient 'cushion' against risk, which could threaten the safety and soundness of the banking system.

The question then is whether competition on the market for credit ratings will spontaneously lead to the elimination of CRAs giving inaccurate assessments of the risk quality of assets. There are several reasons to doubt that good quality credit rating will spontaneously emerge from a competitive market for credit ratings. These include:

1. Regulated financial institutions which have constraints on the credit worthiness of the assets they can hold to meet their capital requirements may have an interest in having CRAs underestimate the riskiness of some of their assets, so that they can more easily meet their capital requirements. In such cases, CRAs may be tempted to collude implicitly or tacitly with their clients to underestimate the risk of their assets.
2. There is the possibility of conflicts of interest for CRAs. Issuers who buy credit rating services may be tempted to pressure a CRA into issuing a higher rating if they are not capitalistically independent of the issuers, or if the issuer accounts for a large percentage of the CRA's revenue. Furthermore, CRAs sometimes provide other services besides credit ratings. These include comprehensive analyses of ratings for investors and market professionals, who are often paying-subscribers, access to databases and tools for research and credit-risk modelling, general information services, such as general news, macroeconomic and industry analysis, impact of current events, market trends, and credit default surveys. They also supply 'rating assessment services' for strategic projects, which involves giving an opinion on potential ratings, given scenarios described by the issuer for strategic acquisitions, mergers, and spin-offs. The provision of these services may lead to a conflict of interest in the CRA-issuer relationship if the issuers are tempted to buy some of those services from their CRA to obtain higher ratings.
3. It is far from obvious that market competition will necessarily lead CRAs providing poor quality (that is, unreliable) credit ratings to exit the market because the demand for credit rating services seems to be inelastic to price and to qual-

ity. Indeed there are no close substitutes for the service rendered by CRAs, and each issuer tends to buy credit-rating services from several CRAs.

4. Structural competition between CRAs is at best weak. The market for credit rating services is dominated by three major rating agencies acting worldwide (Standard & Poors, Moody's, and Fitch Ratings), which together have a 90 percent market share and the remaining 10 percent is shared by a number of smaller, regional and (or) specialised agencies. In addition, there are high 'natural' barriers to entry. As the Committee of European Banking Supervisors (CESR, date and page here please) has noted: "New CRAs face a number of natural barriers to entry. ... The very nature of the CRA market might make it difficult for new CRAs to succeed. Issuers usually only desire ratings from those CRAs that are respected by investors. ... Investors could be reluctant to accord the ratings of a new entrant the same regard as those of established CRAs, because new entrants lack historical default rates by which investors can compare their performance to that of other CRAs. As a result, issuers may be reluctant to engage a new entrant for a rating. Without investor or issuer interest, it may take considerable time for a CRA's rating business to become self-sustaining". In addition, there has been concern that the fact that regulators use the 'credibility' criteria to recognise CRAs for regulatory purposes may further increase the dominant position of the established CRAs – and thus potentially diminish credit-rating quality, since smaller, recently created, or foreign CRAs that might produce objectively reliable ratings obviously have greater difficulty in doing so.

Over recent years, the debate has thus been about what should be done to ensure reliable credit rating services. Some have argued that there is no need to regulate CRAs, since regulation is costly and serves only the purpose of protecting investors who do not have the competence and resources necessary to conduct their own, in-depth credit analysis. According to this view, disclosure of CRAs' conflicts of interest and methodologies should be sufficient for those investors to assess whether credit ratings are reliable, and to discourage them from using unreliable CRAs. However, others commentators consider that because credit risk assessments are incorporated into a variety of contractual and regulatory structures, investors and lenders no longer have the option to rely on them or not, and in most cases must rely on several CRAs. As a result, competition cannot discipline the market and ensure good-quality risk assessments. One option would then be the regulation of credit ratings. Another would be the regulation of CRA activities (such the imposition of a code of conduct to ensure the integrity of the credit rating process) as a means of ensuring credit-rating reliability.

Whereas self-regulation was the preferred solution until the beginning of the crisis, recently the regulatory option has gained ground in Europe. However, some questions remain about whether the adopted solution guarantees the maximum amount of competition compatible with the regulatory goals.

In December 2004, the International Organisation of Securities Commissions (IOSCO) published a voluntary code of practice to which a number of CRAs, in-

cluding S&P, Moody's and Fitch have since adhered[11]. On 19 May 2008 the Chair of the CESR task force on CRA, stated: "The events of last year surely merit a thorough re-evaluation of the current self-regulatory regime". *The European Regulation on Credit Rating Agencies* was approved on 23 April 2009. It aims to ensure that ratings will be: 'independent, objective and of adequate quality'. It establishes a mechanism for CRAs to be registered with their home member states' competent authorities, and for their EU affiliates to be supervised by a 'college of supervisors' co-ordinated and moderated by CESR. A CRA's home regulator can withdraw the CRA's registration, pursuant to the processes set out in the Regulations. Credit institutions (that is, banks) may only use, 'for regulatory purposes' (that is, for the calculation of regulatory capital), ratings which have been issued by a CRA that is registered within the European Union, or satisfies 'equivalence criteria' which are defined in the regulation. Under certain conditions, registered CRAs can endorse the ratings of entities or instruments given by their affiliates outside the European Community. The conditions are that the registered CRA can verify on an ongoing basis that the conduct of the third country CRA operates under a no-less-stringent supervisory regime; that there is an objective reason for the rating to be performed in the third country rather than within the European Community; and that there is an 'appropriate' cooperation agreement in place between the national regulator of the registered CRA and the third country CRA's regulator. Ratings of third country CRAs relating to third country instruments or entities may be used by credit institutions for regulatory purposes provided (amongst other things) that a cooperation agreement between the Commission and the third country regulator is in effect; that the European Commission has adopted an 'equivalence decision' confirming the standards of regulation in the third country equivalent to EU standards, and that the third country CRA has been 'certified' by the CESR.

The regulation aims to set behavioural standards for CRAs, such as increasing transparency and improving their standards of corporate governance. For example, the regulation imposes standards of internal governance to ensure (amongst other things) that CRAs manage any conflicts of interest, have independent compliance departments, and review their rating methodologies periodically. Additionally, the analysts or persons who approve ratings must not "make proposals or recommendations, whether formally or informally, regarding the design of structured finance instruments on which the credit rating agency is expected to issue a credit rating". The regulation also prescribes time periods during which former analysts may not take up certain positions within entities they have rated. Those conditions are fairly similar to the prescriptions set out in the IOSCO *Code of Conduct*. This regulation imposes an increased administrative, disclosure and supervisory burden, although for CRAs that already comply with the IOSCO *Code of Conduct Fundamentals*, the transition required to be regulation-compliant may be less than the changes that they have already undertaken.

[11] This code was updated in 2009.

However, as some commentators have pointed out, for third country CRAs looking to do business within the European Union, and for EU credit institutions looking to buy securities rated only by third country CRAs, the impact of the regulation may be considerably harsher. Thus, whether the regulation reflects the right trade-off between competition and regulation and the promotion of competition is open to debate[12].

2.3 Measures aimed at preventing the extension or the deepening of the economic crisis in the real sector

Stimulus packages are plans intended to contain the scale of the downturn, to stimulate demand and confidence, and to boost long-term competitiveness. They tend to propose countercyclical macroeconomic responses to the crisis in the form of ambitious sets of actions to support the real economy. Most stimulus package measures tend to boost demand. Some measures, however, boost supply of specific products.

Typical stimulus measures include:

- Direct aid to ailing business firms or small and medium-size firms which are collateral victims of the credit crisis;
- Subsidised interest rates;
- Sectoral aid designed to boost demand in specific sectors.

For example, in the United States the $787 billion stimulus program was aimed to favour certain sectors, including automobiles, telecommunications, health, and green energy. With respect to the general stimulus packages, a widely quoted report of the World Bank published in early 2009 (Gamberoni and Newfarmer, (2009) notes that some countries, fearing leaks may benefit foreigners, have inserted discriminatory conditions into their fiscal programs to prevent such seepage when they consider using budgetary deficits as a means to support demand.

A good example of the discriminatory nature of such a plan is the attempt to introduce sweeping ‘Buy American’ procurement rules in the US plan. The *American Recovery and Reinvestment Act* (ARRA) adopted in February 2009 includes two provisions that require government procurement of US-produced products. One provision requires the use of US-produced steel, iron, and manufactured goods in public works funded by the ARRA, subject to certain exceptions (public interest, non-availability or unreasonable cost). The second provision requires the Department of Homeland Security to procure US-manufactured textile and apparel goods. However, following President Obama’s intervention, the ARRA requires that these provisions be applied in a manner consistent with US obligations under international agreements. Further, Congress has indicated that the Buy American provision for iron, steel, and manufactured goods is not intended

[12] Edmund Parker et al. (2009)., Miles Bake and Kevin Hawken, EU Regulation of Credit Rating Agencies approved, 24 April 2009, www.mondaq.com

[13] Elisa Gamberoni and Richard Newfarmer, Trade Protection: Incipient but Worrisome Trends, *Trade Notes*, 2 March 2009.

to apply to LDCs. Even though the US government backed off, to some extent, in response to international pressure, US state and municipal governments will be able to impose restrictions on the origin of steel and manufactured goods in procurement markets[14]. Other countries have followed the US example. For example, in February 2009, Uruguay adopted an anti-crisis program including the 'Buy Paraguayan' plan, which establishes a 70 percent preferential margin for domestic firms in government procurement.

China also adopted a large stimulus package (worth $ 586 billion) at the end of November 2008. A notice issued by several central state agencies, including the powerful National Development and Reform Commission, on May 26, 2009 asserted that purchasing by local governments had actually been biased in favour of foreign suppliers (Johnson, 2009)[15]. The notice requires that in the future only Chinese companies should receive contracts for government stimulus projects unless Chinese companies cannot deliver certain technical goods at a reasonable price or time frame.

With respect to sectoral aid, a number of markets have been deeply affected by the consequences of the financial crisis. The automobile sector is one of them. As a result, a number of countries have taken specific measures to help this industry. For example, besides the United States, Argentina, Brazil, the United Kingdom, Canada, China, France, Germany, Italy, and Sweden, which have all provided direct or indirect subsidies to carmakers, Australia provided support to its car dealers and South Korea and Portugal supported their components suppliers. The World Bank estimates that proposed subsidies for the car industry amount to $48 billion, mostly in high-income countries. Nearly 90 percent of this was in rich countries, where it was part of budgetary packages to stimulate demand. From the standpoint of competition, such measures may have adverse effects on competition if they are designed, voluntarily or involuntarily, in a discriminatory way (that is,, if they benefit some competitors but not all market participants).

For example, as reported in the Wall Street Journal, (Davis and Hilsenrath, 2009) in the farm-equipment sector Deere & Co's purchase of a thrift years ago qualified it in December 2008 for a government guarantee on $2 billion of its debt through a Federal Deposit Insurance Corp. program to help banks access debt markets. But the FDIC did not cover competitors, such as Caterpillar Inc., or smaller equipment providers. So the Equipment Leasing and Finance Association, a trade group, lobbied the Fed to expand the TALF program to sales of farm equipment and other machinery. We are told that, "The Fed eventually expanded TALF to cover Deere, Caterpillar and other equipment makers", but it seems that this result was due to the lobbying of the trade group, and not to an intervention by US competition authorities. Even so, the Fed can only finance borrowers with

[14] For example, the Canadian press has reported that a Toronto area company that exports water treatment technology to the United States, Hayward Gordon Ltd., has been pursuing a Maryland contract that could be worth $200,000; but the bid document asks the company to "provide a list of all iron, steel and manufactured goods 'not' produced in the United States to be precluded from the funding".

[15] Ian Johnson "China Wants its Stimulus to be a Buy-local Affair", *Wall Street Journal* June 18, 2009.

top credit ratings, which is hurting some smaller equipment-leasing firms that cannot get the high ratings and have to pay as much as four percentage points more than higher-rated firms to enable them to borrow.

For example in France, in addition to an auto bailout plan which dedicated up to $7.7 billion (€6 billion) to the failing auto industry in the form of credit lines, a French 'Cash for Clunkers' scheme was implemented in December 2008 and will run through to the end of 2009. A controversy erupted in February 2009 as to whether the French auto bailout plan was compatible with EU competition rules. On 5 February 2009, President Sarkozy indicated that he wished that: "the movement toward relocating plants outside France be stopped and that, if possible, jobs be repatriated to France". He added: "If financial aid is given to the automobile sector for restructuring, it is on the condition that no new plant will be moved to the Czech Republic or elsewhere". On 10 February 2009, the EC Competition Commissioner's spokesperson stated that if the aid granted by the French Government to the automobile industry was conditioned on the fact that the recipients had to maintain their production units in France, such aid would be illegal under EU competition rules. That same day, the EU presidency (exercised under the rotation system by the President of the Czech Republic) denounced the ' protectionism' of the French Government. So did the German Government. On 11 February 2009, EC Commissioner Neelie Kroes wrote to French governmental authorities to ask them for the detailed provision of the automobile sectoral aid plan, and on 27 February 2009 the Commission approved the aid measures.

Another good example of support measures which distort competition is provided by the 'cash for clunkers' bill which was discussed in February 2009 by the US Congress. Incentives of up to $7000 were to be provided to owners of vehicles at least eight years old to purchase fuel-efficient models, but the incentives were to apply only to vehicles built in North America, and would favour US-made vehicles over Canadian-made vehicles.

Some of the sector-specific or firm-specific bailouts which are theoretically responses to the crisis occasionally benefit firms which were doing poorly before the eruption of the financial crisis but are considered national champions. In such cases the economic and financial crisis seems to serve to a large extent as a pretext for justifying industrial policy measures and the bailouts granted may not only distort competition but may also, in certain cases, compromise the return of the industry to good economic health. The case of the bailout of Elpida Memory Inc. by the Japanese government in July 2009 is a telling example[16].

[16] A number of news articles were used for this analysis including: "Some DRAM Makers Move To Raise Contract Prices In January", 6 January 2009, *Dow Jones International News*; Spansion Woes To Aid Peers In Tough Market", Jessie Ho and Yun-Hee Kim, 3 March 2009, *Dow Jones International News*; "Taiwan DRAM chip bailout won't stem decline" Eric Auchard, 4 March 2009, *Reuters News*; "Japan prepares support for Elpida, eyes public funds" , 15 April 2009, *Reuters News*; "Chip makers are in merger talks – NEC Electronics-Renesas deal seen as critical to survival of Japan's semiconductor sector", Daisuke Wakabayashi, 28 April 2009, *The Wall Street Journal Asia*; " Japan's Elpida set for 1.7-bln-dollar rescue", Kyoko Hasegawa, 30 June 2009, *Agence France Presse*; " Japan Props Electronics – Tokyo Launches Aid Program With a Loan to Elpida", Yuka Hayashi and Daisuke Wakabayashi , 1 July 2009, *The Wall Street Journal*; " Elpida's bail-out", Lex Column, 1 July 2009, *Financial Times*.

The semiconductor industry as a whole is considered strategic in many countries because of the increasing role electronics play in defining world-class industries. Chipmakers, eager to undercut rivals, have repeatedly overinvested in boom cycles, and sought help from governments, suppliers, or customers in times of declining demand. Government support helped sustain a large number of competitors – especially in Taiwan – which in turn led to repeated episodes of over-investment, oversupply, and falling prices. As a result, industry bailouts are in vogue with governments seeking to preserve jobs and competitiveness in the world economy.

Elpida Memory Inc. was set up in 1999 as a joint venture between NEC Corp. and Hitachi Ltd. In 2003, Elpida Memory Inc. took over the DRAM operations of Mitsubishi Electric Corp. for the production of dynamic random access memory (DRAM) chips. It is the world's third-largest maker of chips used in mobile phones and other home electronics. For a number of years, it has faced growing competition from rivals such as South Korea's Samsung and Hynix and it has entered a partnership with Taiwan Memory – the company set up by the Taiwanese government to rescue Taiwan's chip sector.

The chronic overcapacity in the microchip industry and a sharp decline in demand in 2008, due to the economic crisis, have led to a slump in prices. Contract DRAM prices hit a record low during the latter part of December 2008, forcing chip-makers to sell their chips at less than the cash cost of producing them. In 2008, the global industry lost a combined $7 billion on sales of $23.6 billion. Elpida Memory Inc. incurred two years of heavy losses and lost 178.9 billion Yen in the fiscal year ending in March 2009.

Desperate to catch up with Samsung and Hynix, Elpida Memory Inc. and its Taiwanese production partner, Powerchip, invested heavily in new capacity in the last few years, despite the downturn, and even though analysts were sceptical of the wisdom of such a strategy, because they did not see any significant recovery for the DRAM market in the foreseeable future as users turn to web-based services like Google Inc.'s Gmail to store information instead of using memory on their own computers. But as one observer put it: "the memory industry suffers from more corporate egotism and national pride than most sectors". However, at the beginning of 2009, after two years of heavy losses, the investment capacity of Elpida Memory Inc. had disappeared.

In recent years, the Japanese government has been prompt to denounce subsidies given to Elpida Memory Inc.'s competitors and to protect it from what it considered 'unfair' international competition. It cried foul after Korean state-controlled banks helped out Korea's Hynix, the world's number 2 maker of dynamic random access memory, which received Korean government aid in 2001 and 2002. But in April 2009, the Japanese trade ministry was forced to scrap tariffs on South Korea's Hynix, following a ruling by the World Trade Organisation and an investigation that said Hynix was no longer receiving government aid.

Simultaneously, however, the Japanese government was looking at ways of providing support to Elpida Memory Inc., including possibly injecting public

money. The Japanese government has described Elpida Memory Inc. as vital to Japan's economy. As Toshihiro Nikai, the Japanese minister of economy trade and industry explained in early July 2009: "Elpida is the only company in Japan that manufactures [dynamic random access memory] and it faces an extremely difficult situation". "Securing [DRAM] supplies is essential to support people's lives and activities in the economy and industries. ... If Japanese manufacturers have to procure chips only from Hynix or Samsung that will reduce their international competitiveness. ... Ensuring a supply of the chips benefits the lives of Japanese people as well as their economic activities". But in the first few months of 2009 the Japanese Government was worried that providing aid to Elpida Memory Inc. could anger overseas rivals, given the long history of contention between Japanese and Korean manufacturers. Reflecting this worry, a Japanese trade official confided, anonymously, on April 15 2009[17]: "Say we want to inject public money. How can we do that in a way that would be palatable for investors without antagonising overseas regulators?"

In the spring of 2009, the Japanese government prepared legislation to allow companies hit by the global economic crisis to apply for public funds and Elpida Memory Inc., which was already raising 46 billion Yen ($467 million) by issuing mainly preferred shares to suppliers, said it would consider applying for government funds once the scheme was in place.

An important specificity of Japan's program is that it allows the government to make investments in manufacturers even before the companies nears bankruptcy. The program targets nonfinancial companies with at least 5000 employees that are deemed to have good prospects of revival within three years. As Shinjiro Takagi, a former government official who played a role in the past in the restructuring of troubled companies stated: "This can be seen as an industrial policy by the government to help these companies and prevent hollowing-out of industries".

On July 1, 2009, the Japanese trade ministry approved Elpida Memory Inc.'s three-year restructuring plan aimed at bolstering its financial situation by introducing cutting-edge facilities in Japan to manufacture lucrative types of memory chips to increase its market share, while shifting production of some other products to Taiwan. Simultaneously, Elpida Memory Inc. became the first company to receive public support under the program enacted earlier by the Japanese government to bail out companies struggling with the global economic downturn. Elpida Memory Inc. was thrown a 160 billion Yen ($1.7 billion) financial lifeline, including public funds, to help it survive the economic downturn by enacting its restructuring plan. Elpida Memory Inc. will sell securities worth 30 billion Yen ($310 million) to the government-backed Development Bank of Japan. If the bank incurs any loss on the investment, the government will cover the bulk of it. The Japan Development Bank will also extend a loan of 10 billion Yen to Elpida Memory Inc. Elpida Memory Inc. is also expected to receive an in-

[17] Prepares Support for Elpida, Eyes Public Funds", 15 April 2009, *Reuters News*.

vestment of 20 billion Yen from the Taiwan Memory Company, a state-backed company set up to boost the island's memory-chip industry. Finally, private-sector banks will offer it loans totalling 100 billion Yen under the government program aimed at providing funds to companies hit hard by Japan's recession.

News reports suggest that chip makers NEC Electronics Corp. and Renesas Technology Corp., which are in talks for a possible merger, are also considering applying for public funds. Altogether, aid was granted to Elpida Memory Inc. by the Japanese Government, even though the chip manufacturer was not on the verge of bankruptcy, even though no systemic risks were alleged, and even though Elpida Memory Inc. (and the entire industry) were in great difficulties before the crisis hit and were independent of it. Observers agree that this aid will help it meet its huge debt and corporate bond repayments. They also point out that it will not solve the overcapacity of the industry in the face of declining demand which may not be revived for several years. Worse, the aid to Elpida Memory Inc. may trigger retaliatory measures in Korea and contribute to increase the imbalance between supply and demand of DRAM microchips.

2.4 Protectionist measures

Protectionist policies as a response to the crisis come in many forms[18]As we have seen, developed countries frequently resort to subsidies to troubled industries but they more rarely resort to erecting border barriers (such as custom duties increases). This is due to the fact that global sourcing has changed the political economy of protection. The preference for subsidies to troubled industries reflects the fact that industries in developed countries import many of their components[19].

But direct protectionist border barriers are occasionally erected even in developed countries. For example, the United States gave in to lobbying by the Teamsters Union and US trucking interests and, as part of the US economic stimulus package, the US Congress cancelled a 2007 demonstration project allowing importation of some Mexican trucks into the United States, thus violating a provision of the 1994 *North American Free Trade Agreement* permitting Mexican trucks to carry goods to and from the United States. In response, Mexico is imposing tariff increases on 90 US products, with a value of $2.4 billion.

The resurgence of antidumping actions (initiated by developed and developing countries) is another observable trend. Parallel to a substantial increase in cases at the WTO in 2008, antidumping proceedings at the national level also seemed to be on the rise, and trade frictions led to acrimonious debates. A World Bank report states that between 1 July and 31 December 2007 the reported number of initiations declined by 7 percent compared to the number reported during the corresponding period in 2006. However, during the first half of 2008 (1 January to 30 June 2008) the situation changed and on 20 October 2008 the Secretariat

[18] Globalisation and Trade: The Nuts and Bolts Come Apart, 16 March 2009, from *The Economist*.
[19] Globalisation and Trade: The Nuts and Bolts Come Apart, 26 March 2009, from *The Economist*.

reported a 'surge in new antidumping measures' of 39 percent compared to the corresponding period of 2007. India was the biggest initiator of antidumping actions, accounting for 29 percent of total initiations. In December 2008, India initiated actions involving both hot and cold rolled stainless steel products and affecting 19 countries (including Japan, China, South Africa, and Thailand). The United States and the European Union imposed duties most frequently. According to the World Bank report, in December 2008 the European Union imposed duties on preserved fruits from China as well as on imports of welded tubes and pipes of iron or non-alloy steel from Belarus, China and Russia. The Report of the WTO Director General to the Trade Policy Review Body of this organisation at the end of March 2009 notes that the trend toward more numerous antidumping actions at the national level has continued in 2009. For example, in January 2009 the European Community imposed antidumping duties from 26.5 percent to 85 percent on imports of certain iron or steel fasteners from China. In February 2009 the EC imposed provisional antidumping duties of 3.7 percent, 8.6 percent, or 24.9 percent on imports of certain bars and rods, of iron, and non-alloy steel or alloy steel other than of stainless steel, originating in China and Moldova. China initiated an antidumping investigation on Terephthalic acid imports from Thailand and Korea.

Antidumping investigations against Chinese footwear imports have been initiated in Argentina, Brazil, and Canada. In early March 2009 Argentina initiated an antidumping investigation on road wheels for trailers and semi-trailers imported from China. Brazil imposed definitive antidumping duties on: phenol (from the European Union and the United States); glassine papers (from Finland and the United States); and ammonium nitrate (from Russia and the Ukraine). In March 2009, the European Union also imposed provisional antidumping duties on imports of 'biodiesel' originating in the United States for a maximum period of six months. That same month, the United States imposed antidumping and countervailing duties on welded stainless steel pressure pipes from China, and Canada imposed final antidumping and countervailing duties on aluminium extrusions from China.

US steel mills filed a suit with the US Department of Commerce on 8 April 2009, complaining that rising imports from China have hurt the US steel industry, provoking a sharp reaction from China's Ministry of Commerce accusing the United States of blatant protectionism and declaring that it would pay close attention to the suit filed by the United States which could be worth $2.7 billion.

Whereas tariff increases represent, according to the World Bank report, about one-third of the protectionist measures implemented between October 2008 and February 2009, they represent about half of the measures implemented by developing countries. Indeed, in many developing countries applied tariff rates on imports are significantly lower than bound duties, which means that tariffs can be raised legitimately without governments having to face the sanction of WTO action. For example, in October 2008 Turkey imposed additional duties as a safeguard measure imposed on imports of cotton yarn from all countries. In Decem-

ber 2008 it imposed import tariff increases on a number of products such as iron-steel – hot rolled flat products (up to 13 percent); iron-steel cold rolled flat products (up to 14 percent); iron-steel-coated flat products (up to 6 percent to 15 percent); wheat, buckwheat, rye, barley and oats, unprepared cereal straw and husks (from 50 percent to 80 percent), and dried apricots, prunes, and apples (from 41 percent to 43.2 percent).

In January 2009, Ecuador raised its customs tariffs on 630 products (from cereals to cell phones and tennis shoes), accounting for 8.7 percent of its imports, for one year to restore its balance of payments. Russia imposed temporary increases of import tariffs on a number of products such as cars (up to 30 percent); trucks (up to 25 percent); buses (up to 25 percent); particular types of flat metals (up to 15 percent); particular types of ferrous metal pipes (up to 15 percent-20 percent); butter and certain types of dairy products, milk and dairy cream (up to 20 percent); and rice and milling products.

In February 2009, Indonesia increased import tariffs on 17 tariff lines such as petrochemical, steel, and electronic parts.

In March 2009, the Ukraine imposed import duty surcharges up to 13 percent, except for 'critical imports', for a period of up to six months, with a view to restore its balance of payments. That same month, Vietnam increased import tariffs on semi-finished products of iron or non-alloy steel from 2 percent to 5 percent; and for bars and rods of iron or non-alloy steel from 5 percent to 12 percent.

A number of developing countries have also resorted to non-tariff barriers, sometimes called 'creative protectionism'. For example, in November 2008 India introduced licensing requirements for imports of certain steel products and auto parts. Also, in November 2008, Malaysia imposed new technical regulations for 57 steel products, requiring certificates of approval for conformity with Malaysian Standards. In December 2008 and January 2009, China tightened safety rules and stopped imports of a wide range of European food and drink products, including Irish pork, Belgian chocolate, Italian brandy, British sauce, Dutch eggs, and Spanish dairy products. In January 2009, India tightened its safety rules and banned Chinese toys.

In February 2009, Argentina introduced reference prices covering around 1000 imported products considered sensitive (such as auto parts, textiles, TV, toys, shoes, and leather goods) and further non-automatic import licensing requirements, covering products such as textiles, steel, metallurgical products, and tires. That same month, Indonesia imposed new licensing, reporting, and pre-shipment inspection requirements on over 500 goods (food and beverages, toys, electronics, footwear, and garments). It restricted entry points for those products to six seaports and all international airports.

Finally, as unemployment increases in many countries, labour policies may have a protectionist dimension. For example on 26 February 2009, US President Obama, in his first budget speech, said his administration would do away with tax breaks for firms outsourcing jobs to overseas destinations, including India. In the

United States, Section 1611 of the ARRA (adopted in February 2009) requires that recipients of *Trouble Assets Relief Programme* (TARP) funds and certain other forms of support comply, for a limited period (two years), with additional attestation requirements when hiring H-1B workers. In the United Kingdom, there has been a debate about the use of Portuguese and Italian contractors in oil refining, which resulted in labour disruption during January 2009. Malaysia is reported to have imposed a ban on the hiring of new foreign workers in key services and manufacturing sectors. Such policies are likely to have serious consequences for developing countries, as their amount of remittance revenues will, in all probability, decrease significantly.

Overall, the World Bank report has warned about the resurgence of protectionist policies, notably among the G 22 member countries, in spite of numerous calls from trade economists and political leaders both in developed and in developing countries against such policies, and in spite of a commitment of the G20 leaders, on 15 November 2008, not to implement such measures. According to this report, since the beginning of the financial crisis, officials around the world have proposed and (or) implemented roughly 78 trade measures. Of these, 66 involved trade restrictions and 47 of these trade-restricting measures eventually took effect. Worse is the fact that 17 of the G20 members have implemented 47 different measures whose effect is to restrict trade at the expense of other countries.

3. CONCERNS FOR COMPETITION RAISED BY MEASURES IMPLEMENTED BY GOVERNMENTS TO FIGHT THE FINANCIAL AND ECONOMIC CRISIS

As is clear from the previous section, a large number of policy responses to the crisis have direct or indirect potential (or, in some cases, are designed) to reduce competitive pressures, either domestically or internationally, on financial markets or on real markets. There is very little concrete evidence of the quantitative impact of these measures on the importance of trade or on the intensity of competition, and it is possible that so far they have had only a limited impact. However there is a concern that, as the economic crisis deepens and unemployment increases, more measures of the types previously described will be implemented in the near future. Thus, even if the measures adopted in the past have only had a limited impact, there is no certainty that this will continue to be the case in the future.

The adoption of measures which, directly or indirectly, restrict trade and competition has led to a lively debate. With respect to the effect of some of these measures on international trade, Paul Krugman[20], discussing the *Buy American Act*, has argued that in the absence of an internationally coordinated fiscal stimulus, such a provision may offset the extra trade benefit enjoyed by countries

[20] Paul Krugman, "Protectionism and Stimulus (wonkish)", 1 February 2009, *New York Times*.

which choose not to stimulate demand through fiscal policy and free-ride on countries which do implement such fiscal stimulus. As he puts it: "My fiscal stimulus helps your economy by increasing your exports – but you don't share in my addition to government debt". But, Krugman's argument does not guarantee that protectionist measures will totally offset the benefits enjoyed by the free-riding countries and therefore cannot be used as an argument in favour of protectionist policies. What Krugman does, however, is point out the fact that the absence of an internationally coordinated fiscal stimulus response to the crisis will create an incentive for countries which implement such stimuli to engage in protectionist anticompetitive policies.

With respect to whether the competition-limiting effect of measures adopted to respond to the crisis, contributes to speeding up or slowing down recovery is also a topic of debate. Protectionist and competition-limiting measures are sometimes justified in reference to the New Deal cartelisation policies, included in the *National Industrial Recovery Act* (NIRA), which suspended antitrust law and permitted collusion in some sectors, provided that industry raised wages above market-clearing levels and accepted collective bargaining with independent labour unions. For example, Eggertsson (2006) [21] argues that government policies that increase the monopoly power of firms and the militancy of unions are expansionary when certain 'emergency' conditions such as zero interest rates and deflation exist, and that these conditions were satisfied during the Great Depression in the United States.

Cole and Ohanian (2004) , have an opposite point of view. They do agree that anticompetitive practices were allowed to develop in the post-depression era and they give interesting evidence on the extent to which competition was disregarded in the United States during the 1930s. In particular, they point out that for a twelve-month period starting in June 1935, the Interior Department received identical bids from steel firms on 257 different occasions, and that these bids were 50 percent higher than foreign steel prices. Wholesale prices in 1935 were 24 percent higher than they should have been, and even by 1939 they remained 14 percent higher. But, according to Cole and Ohanian (date here), cartel prices fed through to unrealistic wages and unemployment was 25 percent higher than it would have been otherwise. The authors conclude that the recovery from the Great Depression would have been much stronger if these policies not been adopted and that the depression may have lasted seven years longer than necessary.

Laeven and Valencia (2008)[23], basing themselves on a study of a sample of 42 well-documented systemic banking crisis episodes (in 37 countries), suggest that accommodative policy measures are fiscally costly and do not necessarily accel-

[21] Gauti B. Eggertsson, *Federal Reserve Bank of New York Staff Reports*, Staff Report No. 264: "Was the New Deal Contractionary?", October 2006.

[22] 'New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis', *Journal of Political Economy*, vol. 112, no. 4. 2004.

[23] In reviewing crisis policy responses it is useful to differentiate between the containment and resolution phases of systemic restructuring.

erate the speed of economic recovery. They also point out that "a lack of attention to incentive problems when designing specific rules governing financial assistance can aggravate moral hazard problems, especially in environments where these institutions are weak, unnecessarily raising the costs of resolution".

Overall, the arguments in favour of a positive link between a restriction on competition or a restriction on trade and the speed of recovery seem rather unconvincing. Even if it were established that a decrease in competition has the potential to speed up recovery, a question would remain about the long-term cost of this acceleration (that is, whether the short-term benefits from boosting the economy would be commensurate with the long-term costs to society, due to the restriction of competition brought about by the policy responses to the crisis).

There is a large body of literature, both theoretical and empirical, linking competition, productivity, growth and innovation. This literature is the basis on which competition law and policy as well as trade policy rest and the sheer fact that we are experiencing a crisis, albeit a severe one, does nothing to render invalid the assumptions on which those policies were built and have expanded over the past several decades. Thus, an important concern is that by engaging in short-term quick fixes, which directly or indirectly limit competition and restrict international trade to try to revive their economies, governments will durably weaken their countries' prospects for economic growth and development. This may occur in two types of situations. In some cases, the anticompetitive effect or the negative impact on trade and competition of the measures considered is clearly perceived, and the adoption of the measures results from a deliberate choice by policy makers (for example, the adoption of discriminatory provisions in rescue packages). In other cases, (such as the adoption of measures to promote domestic consumption or the definition of bailout plans for financial institutions or for firms in the real sector), it is far from clear (at least in some countries) that the policy makers are even aware of the possible implications for competition and trade of the measures they seek to design and implement.

In the EU, rescue schemes and state aid of EU Member States are reviewed by the EU Commission before they are implemented, to ensure their compatibility with competition principles. The EU Commission expresses concerns about the impact on competition of general guarantee schemes covering the liabilities of financial institutions. While recognising that they might constitute an effective tool for contributing to financial stability and maintaining credit supply to businesses, the Commission imposes conditions on such schemes, such as the fact they must be non-discriminatory, limited to the strict minimum, and provide for private-sector contributions as well as for remuneration, and create no undue distortion of competition. As a practical matter, the Commission focuses on three elements in its review of national general schemes covering the liabilities of financial institutions: first, on eligibility criteria, to avoid discrimination; second, on pricing, to make sure that prices come as close as possible to the market price and reflect the beneficiaries' risk profiles and third, on safeguards to minimise distortions of competition.

As far as recapitalisation schemes are concerned, the same principles are applied by the EC Commission. It requires that the pricing of state capital injections into fundamentally sound banks be based on base rates set by central banks to which a risk premium is added, that it has to reflect the risk profile of each beneficiary bank, the type of capital used and the level of safeguards accompanying the recapitalisation. But in most countries state aid is outside the scope of competition law and competition authorities are not always in a position to advocate for competition when measures which may have adverse effects on competition or trade are being drafted, much less to impose conditions to ensure their innocuousness.

In contrast with the European Union, in the United States antitrust is a statutory law and thus is not guaranteed by the US Constitution. Also, in normal circumstances, state aid is granted by individual states rather than by the US Federal government. There is no mechanism providing for the scrutiny of federal aid from the standpoint of its impact on competition. As an example, in a recent discussion at the OECD Competition Committee, the then Chairman of the FTC, Bill Kovacic, admitted that he had waited in vain for a phone call from the Treasury Department or the White House to consult him or his office on the drafting of the bailout plans for US automobiles manufacturers.

Besides rescue schemes, the rise in protectionist measures is a second (and serious) source of concern, not only because such measures tend to restrict competition and trade directly (at a time when trade volumes tend to decline as a result of the economic recession due to weak demand and a decrease in trade financing). It is also because the adoption of such measures leads to retaliation which will further affect trade and competition.

Furthermore, attempts by governments to safeguard their domestic industries at the potential expense of others entail the risk of escalation, with governments outbidding one another to attract economic activity, ultimately leading to a subsidy race. For example, Canada has already matched the subsidies the United States gave Detroit automakers to ensure that the Canadian plants of American automakers would remain open[24]. Similarly, the adoption in May 2009 by China of a directive to ensure that Chinese firms rather than foreign firms be awarded contracts for government stimulus projects seems to have been partly a response to what the Chinese government felt was foreign protectionism against Chinese products[25]. The adoption by the Chinese government in May 2009 of export quotas and tariffs on raw materials (such as bauxite and fluorspar which are used to make aluminium products) was an attempt to help the industry weather a slump in overseas shipments, and it led to a rash of complaints and antidumping investigations from China's trade partners[26]. In particular, Australia launched an in-

[24] David Crane, "Protectionist Measures Delay Recovery: A Key Lesson from the Great Depression is that Protectionism Made Everyone Worse Off", *Toronto Star*, 26 March 2009.

[25] Ian Johnson "China wants its stimulus to be a buy-local affair", *European Wall Street Journal*, Thursday June 18 2009.

[26] Jamil Anderlini and Tom Braithwiate, "Beijing Rejects Allegations of Protectionism", *Financial Times*, June 25 2009.

vestigation into allegations that Chinese producers had dumped aluminium products at below market prices on the Australian market. Also, India imposed duties of between 14 and 30 percent on imports of Chinese aluminium flat-rolled products.

Concern about the use of such measures is important, because multilateral agreements provide little insurance against domestic subsidies, use of antidumping or the other forms of protection. WTO action against subsidies is not easy. Brunel and Hufbauer (2009) , argue that the support of the United States and of most other countries for their auto industries falls within the purview of the WTO definition of actionable subsidies. But, they explain: "fuel-efficiency and environmental standards complicate the issue, and bringing a case to the WTO based on environmental mandates would be hard to justify politically. Moreover, since virtually all major auto exporters have implemented some auto industry aid, any country that brings the first case to the WTO can expect to be challenged with a case against their own auto measures. Therefore, it is unlikely that WTO cases will arise on auto-assistance measures" (Brunel and Hufbauer, 2009). In such circumstances, the imposition of national countervailing duties, further eroding international trade, is the more likely response. But even if countervailing duties are imposed, it is far from obvious that the target country will abandon its subsidies as it has another option, which would be to reduce its exports.

Finally the proposed extension of regulations in the financial sector raises a third general concern about the extent to which the design of such regulations is likely to have either incentive-distorting effects or anticompetitive effects. A large body of research on regulatory reform has been undertaken by the OECD (and elsewhere). This research suggests that poorly designed product market regulations are a serious impediment to competition, employment, productivity, and growth in many economies[28].

There are a number of links between deregulation of product-markets and employment. Studies suggest that easing anti-competitive product market regulation may have a positive effect on employment (see, for example, Blanchard and Giavazzi, 2003; Nicoletti and Scarpetta, (2005); Griffith, and Harrison, (2004); Griffith, Harrison, and Macartney et al., (2007) . Reducing barriers to entry curbs the market power of incumbents and makes entry of competitors possible. This would raise the activity level and thus labour demand. More intensive competition lowers product-market rents and, to the extent that these rents are partly appropriated by workers with bargaining power, decreases wage premia helping to close the gap between wages and Fiori, Nicoletti, Scarpetta and Schiantarelli (2007); Griffith, Harrison and Macartney (2007) . It has also been suggested that competition, by putting downward pressure on prices of goods and services, raises real wages, which stimulates labour supply. At a more general level, other studies show that competition on product markets forces companies to be more efficient and to increase labour or multi-factor productivity, for instance by adopting new

[27] Claire Brunel and Gary Clyde Hufbauer "Money for the Auto Industry: Consistent with WTO Rules?", Peterson Institute.

[28] For a comprehensive analysis see Wölfl et al. (2009).

technologies and being innovative. Nicoletti and Scarpetta (2003) show that countries in which public ownership in the business sector is limited, and barriers to entry are low, are more successful at improving multi-factor productivity growth (MFP) than countries with stringent anti-competitive regulation are. Some studies find a positive link between regulation and productivity at the firm level Arnold, Nicoletti and Scarpetta (2008), thus complementing the industry-level analyses. These studies suggest that burdensome regulations are harmful for the ability of the economy to allocate resources to the most efficient firms and for productivity growth in firms operating close to the technological frontier.

What holds for productmarket regulation is also relevant for regulations in the financial market. Whereas it is clear that securing the stability of the financial sector is an important policy objective, maintaining a sufficient level of competition in the financial sector is and must also be an important policy goal. Indeed, at a time when governments are trying to revive the credit market and to stimulate demand, it is particularly important that banks have an incentive to pass on to consumers the advantages they get from cheaper refinancing costs. But a lack of competition (or distorted competition between financial institutions) may prevent this result. Thus, there is a trade off between two objectives in the regulation of the financial sector. This trade off is not always perceived because of the way in which regulation is produced (that is,, without sufficient interaction between sectoral authorities and competition advocates to discuss the least disruptive way of meeting the goal of the regulation). Yet, as was mentioned previously, the regulation of the structure of the banking sector could entail a social cost in terms of reduced competition between banks. Similarly, the regulation of bonuses in financial institutions may lower the incentives for promising managers to pursue a career in this sector. Finally as we have seen, several directions have been suggested for reforming credit rating agencies, with different implications for competition.

The work undertaken in the OECD on the relationship between product-market competition, employment, productivity, and growth has been one of the foundations of the advocacy work undertaken by this institution in the area of regulatory reform. Member countries have been urged to undertake systematic regulatory reform programs, to consider regulatory impact assessments for new laws or regulations and to be peer reviewed on the quality of their regulation. In this context, tools have been designed to identify unnecessary restraints and to develop alternative, less restrictive policies that still achieve government objectives, such as the 'competition assessment toolkit' of the OECD. Similar instruments have been devised in a number of countries. These tools can be used in different ways. The most common use for these instruments is an overall evaluation of existing laws and regulation (in the economy as a whole or in specific sectors). But these instruments can also be used to evaluate draft new laws and regulations (for example, through regulatory impact assessment programs at the centre of government). There is good reason to believe that, at a time when governments feel the urge to engage in sweeping regulation updates for the financial sector, a systematic assessment of the possible effect on competition of these regulatory changes is necessary.

When thinking about the consequences of our brief description of the policy responses to the financial and economic crisis, four elements must be taken into consideration.

1. We must consider the prevalence and the diversity of policy responses which are likely to lead to restrictions in trade and competition. Such responses may imply fiscal incentives, domestic regulations, restructuring of industries, or trade measures.
2. There is no unique reporting system on these policy responses. It is striking from this point of view that the World Bank report and the WTO report, mentioned previously, are based partly on press articles to try to get a comprehensive view of policy responses to the crisis around the world. This may be due to the fact that policy responses to the crisis are diverse, and therefore that they are implemented by different branches of governments.
3. The competition oversight of the policy responses to the crisis, when it exists, is disjointed and, for the most part, limited. For example in the European Union, the Commission controls state aid granted by Member States. But the DG Competition is not consulted on other measures which restrict trade and competition, such as the imposition of antidumping duties. At the level of the EU Member States, not all national competition authorities are consulted on new regulations which limit competition. Even in countries where the law provides that national competition authorities should be consulted, because most such authorities are independent of the executive branch of the government, they do not participate in the final drafting of new regulations or of bailout plans. In the United States, the situation seems even more unsatisfactory, since there is no competition oversight of federal bailout plans. It may be possible that the Antitrust Division of the US Department of Justice is informally consulted on some policy responses to the crisis (the FTC does not seem to be consulted at all); but this process, if it exists, is not transparent and does not guarantee an effective competition oversight. In other countries, competition authorities are for the most part not directly involved in the decisions of the executive branch of the government.

   Yet it is clear that the adoption of policy responses which are thought to have an immediate effect on the level of activity or on the soundness of the financial sector, but unduly restrict competition, will expose the countries where these policy responses are adopted to create a cost in the future. By adopting such measures these countries, sometimes unknowingly, limit their future growth opportunities thus delaying or making impossible the full recovery of their economy.
4. The examples we have mentioned clearly show that the policy responses to the crisis adopted by governments often restrict competition and international trade simultaneously and may lead to trade retaliation. Thus the domestic effect of these policy responses cannot be considered independently of their international repercussions.

4. RECOMMENDATIONS AND CONCLUSIONS

The first recommendation for governments is to achieve a greater coordination of fiscal stimulus schemes. As we have seen, lack of coordination between governments in their effort to revive demand leads to a desire by countries which have the most ambitious stimulus packages to ensure that there will be no leakage for the benefit of countries with less ambitious packages. This pushes the former to include in their plans, or to add to their plans, protectionist measures, which in turn lead to retaliation and the imposition of more trade- or competition-restricting measures.

One of the indirect consequences of the need for greater coordination of fiscal stimulus schemes is that there is also a need to enlarge representation in the institutions of global economic governance. As the Institute of Development Studies argued in a recent brief (McCulloch et al., 2009), and as Dominique Strauss Kahn remarked in a speech at OECD in February 2009, the G20 excludes most of the developing countries and a number of developed countries. This grouping therefore has not only a problem of legitimacy but also a risk of ineffectiveness in promoting international cooperation.

The second recommendation is that world leaders complete the Doha Round of trade negotiations. A reduction of tariff ceilings is urgently needed when, as we have seen, governments are tempted to increase tariffs. A stronger multilateral discipline over protectionist measures is necessary at a time of economic recession. Improving the safeguards mechanism would reduce the temptation of governments to rely on antidumping measures. A lower cap on agricultural and industrial subsidies is required to give some breathing space to developing countries at a time when the demand for their raw materials or manufactured products is declining.

Third, and most importantly, there is a need for governments to be more aware of the fact that all of their direct or indirect interventions in the financial or real markets, whether through stimulus packages designed to increase domestic demand or to support supply, or through protectionist measures, or through regulation are likely to alter (and in many cases to distort or to dampen) competition. They must be reminded that quick fixes or attempts to ensure a safer world are likely to have a long-term cost in term of efficiency and growth. Governments should, at the very least, be aware of the trade offs to be in a position to tailor their responses to the economic and financial crisis.

From this standpoint, it is worth noting that the regulatory reform movement which started in the late 1990s and developed the early 2000s at a time of economic expansion (when there was primarily a need to verify that past legislation still had a valid purpose, and that changing economic conditions did not make this past legislation more restrictive than what was strictly necessary to ensure the attainment of the goals they had been assigned) needs to be adapted to the current situation of economic crisis. Indeed, we are in a period when a large number of new direct or indirect government interventions in market mechanisms are contemplated, as well as the adoption of a large number of sweeping new regulations. Rather than waiting for these changes to take place and then examin-

ing *ex post* whether they have unduly limited competition, there is a need to minimise the risks of disruption due to policy responses to the crisis. In other words, it is necessary to move decisively from *ex post* regulatory reform to *ex ante* competitive assessment of contemplated government interventions.

Furthermore, because a large number of the policy responses adopted by governments have the objective or the effect of limiting international competition, it is in every country's interest to ensure its trading partners will not adopt responses which will limit international trade and competition. Thus, it would be desirable for all trading nations to commit themselves to carry out a transparent competitive impact assessment of all financial rescue packages, state aid plans to particular sectors, or new regulations proposed as a response to the economic and financial crisis, prior to their implementation. In other words we should move decisively from a system of disjointed and optional competition assessment, to a system of comprehensive, mandatory competition assessment of the policy responses to the crisis.

The results of these competition assessments (and the contributions to any public consultations undertaken) should be made immediately available to all the trading partners of the government contemplating the measures as a response to the crisis. Not only would such a commitment enlighten each government contemplating the adoption of policy responses to the crisis as to the long term risks of the measures they consider, but by forcing each government to reveal to its trade partners the impediments to competition they are contemplating, it would facilitate retaliation by these trading partners and therefore it would discourage each government from unduly adopting competition and trade restrictive measures. Thus, we should move decisively to a system of transparent, independent, and public competition assessment.

As we all know: the sun is the best detergent.

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14

Green Growth, Protectionism, and the Crisis

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1. INTRODUCTION

It did not take long after the first hints were given by governments that they were contemplating trillion-dollar economic stimulus packages, in addition to the bail-out packages they had already provided to their financial sectors, that exhortations for a complete re-orientation of spending patterns in support of 'green' priorities took on the characteristics of a mantra. Borrowing from a term last heard during the economic crisis of the 1930s, environmental groups, and even a number of prominent economists, called for a 'Green New Deal', involving massive increases in spending on the environment, particularly investments in lower-carbon sources of energy, which would be matched in a short time by international agreement on an ambitious post-2012 climate regime, and corresponding policy changes at the national level.

Judging from the pattern of stimulus spending so far, governments are heeding these calls. According to analysts for the HSBC Bank plc (Robins et al., 2009), of the nearly $2800 billion in tax cuts, credits and extra spending announced by the world's economies through the end of January 2009, more than $430 billion was targeted at increasing the supply of low-carbon power, improving energy efficiency (particularly buildings and transport) industries, or upgrading water or wastewater infrastructure. The average 'green' share of the stimulus spending is estimated to have been around 16 percent, but approached 40 percent in China (the world leader in 'green' spending) and over 80 percent in South Korea.

That this unfolding shift in policies has been watched with some unease by trade economists is understandable. There are the cautionary tales of the Great Depression, naturally. But there are also lessons to be learned from more recent times. In the wake of the oil crises of the 1970s and early 1980s, and their ensuing recessions, governments poured enormous amounts of money into developing all manner of alternative energy supplies – alternative in that era meaning 'not petroleum'. That much of this expenditure was poorly targeted and wasteful was as good as preor-

[1] The views expressed in this paper are the author's alone, and do not necessarily reflect the views of the OECD or of its Member Countries.

dained. But there were also long-lasting consequences for trade, and for the environment, consequences that are still being worked out today.

This paper argues that the global economic downturn risks not so much increasing the propensity for green protectionism, as providing a broader stage for it. As background, the paper first describes the three faces of green protectionism: blatant, murky, and unintentional. It then discusses the trends in environmental priorities and approaches that pre-date the current economic crisis, and that will continue to influence the shape of environmental and related energy policies long after the crisis is over. The paper then briefly reviews the types of policies and programmes that have been enacted as part of national economic recovery plans, noting that, so far, their protectionism quotient has been remarkably low. Nonetheless, there is plenty of reason for continuing vigilance. The combination of continued anxiety over global energy supplies, plus the strength of the 'renewable energy = domestic jobs' narrative, will continue to be exploited by special interests and policy makers who are less antithetical to protectionist measures than are trade economists. One obvious conclusion is that policy makers need to become more attuned to the early signs of green protectionism and understand how to resist it. In order to be able to do that, however, there needs to be much more transparency on existing as well as proposed policies, and more independent analyses of their effects.

2. WHAT IS GREEN PROTECTIONISM?

The origin of the term 'green protectionism' is obscure, but it was already being employed by the World Wildlife Fund in a brief it prepared for the 5th WTO Ministerial Conference in Cancún (WWF, 2003, p. 1). In that document, the WWF described green protectionism as "the use of measures for narrow protectionist ends under the guise of addressing legitimate environmental goals." More recently, Simon Evenett and John Whalley (2009), while not defining green protectionism, speak of its 'murkiness', and seem to have in mind a definition similar to that of WWF. The definition provides a good starting point but it is too narrow, as it misses out on policies that are unabashedly protectionist, as well as those that are simply ham-handed. Ordered from blatant to unintentional, they can be classified into three categories:

1. The intentional use of tariffs, subsidies (including investment incentives), government procurement preferences, or trade remedies to protect or support a nascent 'green' industry.
2. The strategic use of environmental policies (including 'green procurement') to protect or support a domestic industry, green or non-green.
3. The application of environmental measures in a way that inadvertently creates a trade barrier.

Pure protectionism based on tariffs has become less important in recent years, thanks to the progressive reduction and binding of industrial tariffs under successive GATT-sponsored multilateral trade rounds (augmented by tariff reduc-

tions under regional free-trade agreements). The main exception is fuel ethanol, the production of which is still protected in a number of countries owing to its initial classification as an agricultural commodity. Tariffs are also still high on some environmental goods in developing countries (for example, solar water heaters), but more often because of general industrial protection than of being a specific policy to protect these industries especially. And, finally, a few environmental goods, most notably compact fluorescent lamps, have attracted anti-dumping duties from a number of countries.

More commonly used nowadays to support environmental industries explicitly (services as well as goods) are the other traditional instruments in the protectionist toolkit, notably subsidies and government-procurement preferences. Subsidies to environmental industries are provided mainly by OECD countries and newly industrialising countries. Some of those, such as subsidies for solar power in many countries, are indirect, and non-discriminatory against foreign suppliers of goods and services. Nonetheless, large differences in support levels across countries in some cases (for example, for solar photovoltaic panels) have created market distortions, diverting supplies to the countries that provide the heaviest subsidies and raising prices for consumers elsewhere.

Some support programmes have been discriminatory, however, and new policies of this sort continue to be created. Again, biofuels (fuel ethanol and its corresponding diesel substitute, biodiesel) offer perhaps the most extreme case. However, the policies used to support them – which include in recent years new, volumetric production subsidies, and even in some countries sub-national policies which grant subsidies to producers that use local agricultural feedstock – show that some policy makers are still willing to use whatever it takes to support a domestic industry.

The second category of green protectionism covers the broad panoply of policies that Evenett and Whalley (2009) refer to as 'murky green' – those that may have an ostensible environmental motive, but which also favour domestic producers. They are 'murky' because proving that there is protectionist intent behind them is usually difficult, if not impossible. Perhaps the most straightforward policies in this category are those that compensate producers for the costs of conforming to environmental regulations.[2] One aspect of subsidies for the adaptation

[2] Such subsidies, within limits, received the blessing of the WTO for five years (1995–99) while Article 8 ('Non-Actionable Subsidies') of the *Agreement on Subsidies and Countervailing Measures* remained in force. Under the provisions of this Article, several categories of subsidies were deemed 'non-actionable'. These included ones for "...assistance to promote adaptation of existing facilities to new environmental requirements imposed by law and (or) regulations which result in greater constraints and financial burden on firms. This was provided that the assistance: (i) is a one-time non-recurring measure; (ii) is limited to 20 percent of the cost of adaptation; (iii) does not cover the cost of replacing and operating the assisted investment, which must be fully borne by firms; (iv) is directly linked to and proportionate to a firm's planned reduction of nuisances and pollution, and does not cover any manufacturing cost savings which may be achieved; and (v) is available to all firms which can adopt the new equipment and (or) production processes" (WTO, 2007, p. 241). In the event, no countries provided the prior notification required for them to avail themselves of this safe haven, and the Article was allowed to lapse.

of existing facilities to new environmental requirements makes them problematic from a trade perspective. This is that, as engineers internalise pollution prevention into their designs, it becomes increasingly difficult to identify, separately, technologies designed to meet environmental requirements from those that improve the efficiency with which a facility makes use of material inputs.

Among the early recipients of these types of subsidies were heavy industries, such as steel-making and traditional occupations such as fishing and farming. Following the sharp rises in the cost of energy during the 1970s and early 1980s, for example, and the adoption of tougher regulations on the release of sulphur oxides and nitrogen oxides from the combustion of fuels, many countries provided assistance to their heavy industries to switch to more energy-efficient modes of production. That the investments stimulated by these investments also sometimes helped producers to reduce their operating costs was at first regarded as a happy coincidence. However, State Aid authorities, at least those in the European Union, have since toughened their stance on such subsidies – even those provided in the name of environmental improvement or energy conservation – and have often ruled against support for investments that should have been in the interest of the firms to undertake without government assistance.[3]

Another form of murky green government intervention, which can occasionally be found in the area of chemicals, is regulations banning or severely limiting the use of certain substances. The rationale for such regulations is that the substances have been shown to be potentially carcinogenic, mutagenic or otherwise harmful to humans or the environment. When producers in the country initiating the regulation offer a (slightly) safer or greener patented substitute a commercial motive may be intermingled with a desire to protect public health and safety.[4]

Perhaps just as common as these sorts of government regulations are those for which an adverse impact on exports from another country is truly an unintended consequence – the result of changes in domestic regulations that have no benefit for domestic producers, but which inadvertently reduce the market access of exporters. This sometimes happens in the case of deregistration of pesticides that are no longer being used in the importing country but are still used in other countries.[5] Because such changes in regulations are not motivated by the desire to protect domestic industries, they are no more likely to be resorted to during

[3] See, for example, the Commission Decision of 28 March 2001 on the State Aid which Germany was planning to implement for the steel firm BREMA Warmwalzwerk GmbH and Co. KG http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002D0081:EN:NOT

[4] See, for example, *Limits on aromatic amines in textiles coloured with azo dyes*, Chapter 2 in OECD (2005).

[5] The problem in these kinds of cases lies not so much with any protectionist intent, but with regulations that quasi-automatically revert to a default value unrelated to actual public risks; see, for example, *Limits on pesticide residues in tea*, Chapter 7 in OECD (2005). The WTO's *Agreement on Sanitary and Phytosanitary Standards (SPS Agreement)* has since encouraged governments to adopt residue limits that they can defend based on science, and that are not simply set through some automatic default mechanism. Maybe other 'sleeper laws' exist on the books of some countries, which could in the future trigger the erection of new trade barriers.

economic crises than during any other periods. However, in at least once case since the current economic crisis started (described below), an unintended windfall resulting from an environmental subsidy has led to a copy-cat subsidy in another country.

3. PRE-CRISIS GREEN TRENDS

To assess the risk of green protectionism posed by the current economic crisis, it is helpful to understand trends in environmental concerns and policy responses that were already manifest by the end of the 1990s and were well advanced by the late 2000s.

At the time the economic crisis hit, there was already a growing sense of urgency surrounding big environmental issues. Although the world has previously experienced heightened anxiety over environmental and resource constraints, most notably in the 1970s (see, for example, Erlich, 1968; Meadows et al., 1972), the view that the world is gravely threatened by climate change, biodiversity loss, peak oil, peak water, and even peak soil has in recent years become much more widespread. Back in the 1970s, talk of imminent environmental catastrophe and rapid resource depletion was more easily dismissed as alarmist and uninformed by economics and science. By the dawning of the third millennium – with 2.3 billion more mouths to feed, clothe, and house than in 1970 – many more scientists had joined the chorus, notably organised through such authoritative bodies as the Inter-governmental Panel on Climate Change. By the time of the December 2007 meeting of the Conference of Parties (COP) of the United Nations Framework Convention on Climate Change (UNFCCC), international climate diplomacy had shifted into high gear, and all eyes became focused on the December 2009 COP, at which a new, post-2012, climate regime is due to be hammered out.

By August 2008, several OECD countries had already adopted, or were considering adopting, major economy-wide policies to address their own carbon emissions. However, because of concerns related to the cost of compliance for certain domestic industries, and the possibility that investment and production would shift to countries not undertaking such measures, policy makers in some economies – notably the European Union and the United States – started to speculate openly about adopting so-called 'border carbon adjustment' measures (BCAs) once their schemes were in place. These BCAs would involve either levying a charge on imports (and a rebate on exports), or requiring that importers purchase carbon offsets, such as those sold on the European Carbon Exchange.

Meanwhile, anxiety over the world's increasing dependence on hydrocarbons from the Middle East, and from other nations considered to be unstable in one form or another, increased the pressure on policy makers to develop national capacities to produce and use alternatives to petroleum fuels. And, since the most important use of petroleum nowadays is for transport, that led a large number of countries to support technically proven substitutes for gasoline and mineral diesel – namely, ethanol and biodiesel. Such biofuels, in the majority of cases made from crops, were also looked upon favourably by politicians eager to help their

rural constituencies. By the end of 2007, more than a dozen major economies, both developed and developing, had created regulations establishing minimum shares or volumes of biofuels in their transport fuel mix, usually combined with some form of state aid for domestic producers of those fuels and, in the case of ethanol, high protective tariffs (Steenblik, 2007). These actions, in turn, spurred double-digit growth in the sector, contributing to rising food prices and a subsequent crisis of over-capacity – not as large, but just as deep, as that experienced by the automobile sector.

Another major trend over the last decade has been the enormous growth in the number of voluntary eco-labelling schemes, both governmental and privately sponsored, and especially of what can loosely be called 'sustainability standards'. These latter standards are based on criteria relating to the production and processing of goods and services, rather than to the safety or environmental attributes of the product itself – what trade lawyers refer to as measures based on PPMs. In recent years, a new sort of standard has emerged based on estimates of the emissions over the life cycle of a product, especially emissions of carbon dioxide or greenhouse gases more generally (see, for example, Brenton et al., 2008). Although most such 'carbon footprinting' has been applied by the private sector in the form of information labels, new regulations expected to go into effect in Europe and the United States within the next few years link obligations relating to biofuels or low-carbon fuels to the life-cycle GHG emissions of those fuels.

4. HAS THE CRISIS INCREASED GREEN PROTECTIONISM?

So, has the crisis increased the green protectionism? It is hard to say: in general, developed countries have so far refrained from raising tariffs to protect or support any industry, including green industries. Some developing countries have raised their tariffs, from lower applied rates to higher bound rates, but there is little evidence that these tariff increases have been connected in any way with environmental policies, nor have environmental industries been targeted for special treatment (WTO, 2009a; 2009b; 2009c).

On the other hand, the economic crisis probably has also coincided with a redoubling of efforts by those – namely, OECD – countries that have been calling for progress at the WTO in negotiating a multilateral agreement to reduce or eliminate tariff and non-tariff barriers to international trade in environmental goods and services.[6] On 25 June 2009, all 30 Member countries of the OECD, plus Chile, Estonia, Israel, and Slovenia, adopted a 'Declaration on Green Growth'. This affirmed "...the importance of the liberalisation of trade in environmental goods and services in fostering green growth", adding "We are resolved to ensure that measures taken to combat climate change are consistent with our international trade negotiations" (OECD, 2009, p. 3). However, early on in the WTO ne-

[6] Paragraph 31(iii) of the *Doha Development Agenda*, the negotiating mandate for the WTO's Doha Round of multilateral trade negotiations.

gotiations several key developing countries had rejected the idea of liberalising tariffs on a negotiated list of environmental goods, and proposed instead alternatives such as liberalising trade in such goods on a project-specific basis – something many of them do already. So far there has been little evidence to suggest that the economic crisis has caused these countries to undergo a change of heart.

The crisis may have also made the strategic use of environmental policies to protect domestic industries more acceptable, but again it is too early to tell. Nonetheless, there is plenty of reason for monitoring developments closely. Since March 2009, for example, several countries have provided investment aids to help their car manufacturers develop greener vehicles. Some of these investment aids are being used to fund private R&D into truly new propulsion systems, notably advanced batteries for electric cars. But some may be merely furnishing the means by which car companies that previously chose to concentrate on manufacturing large, gas-guzzling vehicles can retool and start producing vehicles more like those that were already being produced by companies that, prior to the crisis, had astutely pursued the market for energy-efficient cars. Examples of "green" investment aids include $5.9 billion in government-guaranteed loans to the Ford Motor Company to help them upgrade factories in five Midwestern US states to produce a range of fuel-efficient vehicles (Thomas, 2009); a £27 million grant from the UK Government to Jaguar to enable it to develop "the smallest, lightest and greenest Range Rover ever made" (Arnott, 2009, p. 1); and a temporary scheme (until 31 December 2009 with a maximum term of two years) benefiting Spain's car and car component industry that provides interest rate subsidies for the production of environmentally-friendly (green) cars (WTO, 2009c).

In at least one case, a pre-crisis 'green measure' with unintended consequences has led to another country responding in kind. In April 2009, press reports revealed that several American pulp mills were claiming a US tax credit on 'black liquor', a by-product of the pulp-making process that pulp mills have been using as a cheap source of energy for decades (Mufson, 2009).[7] The tax credit had been created in 2005 and was intended to encourage business to use biofuels such as ethanol or biodiesel in their company fleets. But in 2008, several US paper companies sought and successfully obtained a ruling from the tax authorities that the tax credit was also available for black liquor, thus allowing them to reap collectively a several-billion-dollar tax benefit in 2009. Their Canadian counterparts quickly responded, complaining that they were "drowning financially because of the tax windfall for their American rivals" (Egan, 2009, p. 1). In response, on 17 June 2009, the Canadian Government announced a C$1 billion (US$880 million) package for its pulp and paper producers, under which it will pay the companies C$0.16 per litre for black liquor, produced between January and December 2009. Canadian officials have said their subsidy differs from the

[7] According to Mufson (2009), burning the fuel dates to the 1930s, and US paper companies have consumed nearly all of the by-product since the 1990s.

US tax credit because it places a cap on total government expenditure, and companies must spend it on environmental and energy improvements; they may not use it to reduce debt or to increase short-term profits (Egan, 2009).

What is certain is that the crisis has encouraged government investment in environmental infrastructure, particularly that supporting renewable energy, cleaner transport, and water. The HSBC Climate Partnership – a partnership between the international banking group, HSBC, and the Climate Group, the Earthwatch Institute, the Smithsonian Tropical Research Institute, and the WWF – has been closely monitoring government expenditure on green measures since the beginning of the crisis. Its latest analysis, published in February (Robins et al., 2009, p. 2), identified numerous measures relating to transport and renewable energy in particular. These included:

* increased R&D assistance for electric vehicles, hydrogen fuel cells, liquid biofuels;
* consumer incentives, such as bonuses for the purchase of more fuel-efficient or less-polluting vehicles;
* incentives aimed at buyers of new cars to scrap their old vehicles;
* public investments in road networks, rail ($122 billion worldwide), and urban transport;
* increases in budgets to subsidise the upgrading of electricity grids, and the construction of new renewable-energy electricity generating capacity.

Whether, and to what extent, these measures will prove to be trade-distorting depends on the details of how they have been designed and implemented. Naturally, R&D assistance has been targeted at helping those industries for which policy makers see a viable future in the domestic market. It should not be automatically assumed, however, that R&D assistance is viewed as totally innocuous by trading partners: the Airbus-Boeing dispute at the WTO, the largest subsidy dispute the organisation has taken on so far, centres around the R&D money that the airlines have allegedly received, and from which they benefitted. But the fact that several countries have put their money into funding R&D, when they might have been tempted to provide production subsidies, can be seen in a positive light. Moreover, spending on R&D, such as into improvements in electric vehicles, could generate spillover benefits for the rest of the world.

Neither the consumer incentives for greener vehicles nor scrapping incentives provided so far overtly discriminate against imported vehicles. However, their green criteria vary widely, and are arguably tailored to match the strengths of each country's domestic car industry. For example, as Höhne et al. (2009) point out, the criteria used by different countries range from no linkage to improved environmental performance (Germany) to maximum emissions rates (gCO_2/km) of varying levels (France, Italy, and Japan). Enthusiasm for government intervention as a spur to get struggling carmakers to shift to greener designs even led the Finance Minister of Norway, Kristin Halvorsen, to suggest, as from 2015, banning sales in her country of new cars that can run only on fossil fuels; this has not become official government policy, however (Doyle, 2009).

As Metcalf (2009) points out, the way that such policies are designed can lead to wide variations in cost-effectiveness. In the case of the Hybrid Vehicle Tax Credit, created by the US Energy Policy Act of 2005 to encourage sales of cars powered by hybrid gasoline-electric engines, the cost (for 2009 model years) ranges from zero to over $3 per litre of gasoline saved (Table 14.1).[8] Moreover, by favouring a particular technology, vehicles that economise on energy through other means are disadvantaged.

Table 14.1: *Tax Credit per Litre of Gasoline Saved Through the United States' Hybrid Vehicle Tax Credit, Based on Models Sold in 2009*

Make and model	Version	Miles per US gallon	Litres per 100km	Hybrid Vehicle Tax Credit	Annualised value of credit	Annual gasoline savings per vehicle (litres)	Tax credit per litre of gasoline saved
Chrysler Aspen	Hybrid	21	11.1	$2,200	$347	114	$3.06
Ford Escape(2WD)	Hybrid	32	7.3	$3,000	$474	886	$0.54
Mazda Tribute(2WD)	Hybrid	32	7.3	$3,000	$474	886	$0.54
Nissan Altima	Hybrid	34	6.9	$2,350	$371	973	$0.38
Toyota Prius	Hybrid	46	5.1	$0	$0	1,336	$0.00
Toyota Corolla	Non-hybrid	31	7.5	$0	$0	840	$0.00

Source: Original calculations by Metcalf (2009) based on savings relative to a vehicle that can be driven 20 miles on a gallon of gasoline (consumes 11 litres per 100 kilometres) and is driven 12495 miles (20109 kilometres) in a year. Vehicles are assumed to be driven for 10 years and the savings are annualised with a 10 percent discount rate. Rates were converted to equivalent metric units by the author of this paper.

Publicly-supported investments in infrastructure, including public transport, 'smart' electricity grids, and improved water and sanitation, will – so we have been assured – abide by WTO government-procurement rules. Nonetheless, as research by Evenett (2009) has shown, the devil is in the implementation details, and there are already some troubling indications that implementation of the US American Recovery and Reinvestment Act (ARPA) by spending agencies will be guided by instructions that do not always contain the full original caveats requiring compatibility with the WTO Agreement on Government Procurement. Ironically, in the case of water supply and sewage-treatment plants, bottlenecks have already appeared because of the need for foreign-sourced key equipment (Drajem, 2009).

Concerns about local preferences in government procurement were also raised when, in June 2009, China issued an edict affirming that "Government investment projects should buy domestically made products unless products or services cannot be obtained in reasonable commercial conditions in China" (McDonald, 2009,

[8] The tax credit, which ranges from zero to $3000 per vehicle, depends on whether the vehicle meets the specific hybrid criteria and on how many vehicles have been sold. The credit phases out over time as certain sales targets for the vehicle are met.

p. 1). According to Bradsher (2009), when the Chinese government took bids this spring for 25 large contracts to supply wind turbines, every contract was won by one of seven domestic companies, including several companies that had no prior experience in building a turbine. All six multinationals that submitted bids were disqualified on various technical grounds (like not providing sufficiently detailed data), within three days of bidding for the wind farm contracts. Some of the European turbine manufacturers had already built factories in China in order to comply with the country's requirement that turbines contain 70 percent local content. In addition, the Chinese government banned virtually any installation of wind turbines with a capacity of less than 1000 kilowatts – excluding 850-kilowatt designs, a popular size for European manufacturers. In September 2009, the Canadian Province of Ontario also introduced a domestic content requirement, which would ensure at least 25 percent of wind-project costs and 50 percent of large solar-project costs come from Ontario goods and labour (Ontario Ministry of Energy and Infrastructure, 2009). Requirements for solar projects are scheduled to increase on in 2011 and those for wind in 2012.

Not surprisingly, some stimulus package money is being used to rescue troubled industries, including some already heavily dependent on government support. Once again, biofuels stand out. Various OECD countries were already offering incentives to their biofuel industries before the crisis. But what became clear in late 2008 and this year was that several of them have shown that they are committed to keeping their domestic producers in business, often through the provision of new subsidies. Thus, since Q4 2008, at least three countries (Canada, New Zealand, and the United States) have provided new policies aimed at either rescuing existing producers or stimulating projects that had been put on hold because of the crisis.

5. THE NEED FOR CONTINUING VIGILANCE

Economic crises always increase domestic pressure for protection generally. An economic crisis, by itself, neither increases nor decreases the number of green threads in the fabric of protectionism. Indeed, if the Kuznets curve has any validity, then hard times are likely to lead if anything to *reduced* demand for environmental protection. That would suggest a slowing down in the rate of new environmental regulations of the kind that could be used to greenwash protectionism.

However, there are several trends and popular sentiments that could be exploited for protectionist purposes. These include: fears over reduced energy security, inflated expectations over job creation from green investments, the advent of product-level carbon footprinting, and the more general concerns related to leakage and competitive effects of climate policies.

The goal of achieving national-level energy security, usually translated into the more simplistic notion of energy self-sufficiency, feeds on fears. Its appeal rises and falls in line with international energy prices, but is also heightened by

market disruptions such as the 1973–74 Arab Oil Embargo, the Gulf Wars, and Russia's disputes with its neighbours over natural-gas pricing. Domestic energy industries – including industries supplying renewable energy – have become adept at exploiting such periods to lock in subsidies, tax breaks, and regulatory favours, and there is no reason to believe that this situation has changed.

Another problem that could lead to more protection of renewable-energy industries is that, in many countries, advocates of renewable energy and greater government encouragement of green industries have long stressed the numbers of domestic jobs that would be created if only governments would mandate or subsidise the greater use of renewable energy (see, for example, Institute for America's Future et al., 2004). In the middle of this decade, a number of detailed studies were undertaken in the United States to identify how many jobs would be created, and in what states, from major increases in solar and wind capacity.[9] Few of those studies considered what components would more likely be imported than produced domestically.[10] How policy makers will react as they begin to realise that many components of renewable energy are traded just like other goods – as suggested by a recent study prepared by the New America Foundation (Sherraden and Peuquet, 2009) – is difficult to predict.

Policies and labelling initiatives that are based on estimates of the life-cycle CO_2 or greenhouse-gas (GHG) emissions of specific products are also being adopted at a rapid rate. These range from various government-sponsored voluntary and mandatory schemes for labelling the 'carbon footprint' of common products (especially food, clothing, appliances) sold at the retail level, to regulations relating to the minimum GHG savings of biofuels compared with petroleum fuels, or their close relative, low-carbon fuel standards for transport fuels. Given the uncertainty and imprecision of the models and data used in life-cycle analysis (LCA), and the degree of expert judgement involved in LCA, the risk of political pressure influencing the settings of policies in this area is real.

The use of border adjustments as a means to address concerns over carbon leakage and competitiveness now looks to be a strong possibility, with inclusion of provisions in the version of the American Clean Energy and Security Act of 2009 (H.R. 2454: the "Waxman-Markey Bill") passed by the House of Representatives in June 2009. The bill as it passed the House would require importers of heavily traded energy-intensive products to purchase emissions allowances. Exemptions from this requirement would apply to exports from least-developed countries and from states with both low absolute levels of emissions and small import market shares. But for the rest, exemption from the requirement would depend on an assessment of whether the GHG emissions or the energy intensity of the sector in the exporting country was equal to or lower than that of its US competitors, or if at least 85 percent of US imports of the product are coming from countries with binding emissions-reduction targets or lower energy intensity

[9] For a comprehensive review, see Kammen et al. (2004).
[10] A notable recent exception is the study by Pollin et al. (2009).

(ICTSD, 2009). Although the bill still has many hurdles to cross before (or if) it becomes law, its provisions on border carbon adjustment are already attracting attention from trading partners.

6. POLICY IMPLICATIONS

Protectionism is not only a potential problem for the world's trading system, but also to environmental goals. As Evenett and Whalley (2009, p. 1) observe, dressing up protectionist measures in environmental garb can have a chilling effect on environmental negotiations: "Trading partners in the rest of the world will hardly believe that the discretion abused in existing national environmental regulation will not be abused again…". Succumbing to pressures for green protectionism would not only reduce the gains from trade and blunt the spur to technological innovation provided by international competition, it would also undercut the credibility and trust that nations need to maintain as they enter into multilateral negotiations over new and wide-ranging environmental agreements, most notably a post-2012 climate regime (Evenett, Simon and Whalley, 2009). Among economies that are only now beginning to develop their own markets for environmental goods and services, there is a suspicion that calls by highly developed economies for ever more stringent environmental regulations are influenced by their commercial interest in supplying the goods and services needed to comply with those regulations. However unfounded those suspicions may be, any embrace of green protectionism would sustain them.

Whether the economic crisis ends up providing scope for increased protectionism or supporting the positive elements of the 'green growth' rhetoric (for example, spurring countries to reduce tariffs and non-tariff barriers to trade in environmental goods and services) will depend in part on how well policy makers are attuned to the trade effects of environmental policies and can thus recognise the early signs of green protectionism so as to avert it. As in so many areas of policy, a key requirement is transparency on existing as well as proposed policies, and more independent analyses of their effects.

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The Financial Crisis and Financial Nationalism

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1. INTRODUCTION

The financial crisis has necessitated many interventions to support financial systems and resume financial intermediation. By nature, these measures create a distortion directly – as they support financial intermediaries in non-market ways, and indirectly – as they distort financial intermediation and resource allocation. Measures also have international repercussions, most notably when governments extend guarantees to financial intermediaries – that directly distort financial and capital flows, and through capital and other support measures – that often favour national institutions and have a bias towards local lending.

Implications for (international) competition are not obvious however. Competition in the financial sector is a complex issue to begin with. And support during financial distress periods can avoid the elimination of (non-systemic) institutions which may be essential to competition – today and in the future – and to maintain contestability. Nevertheless, and especially given tightly integrated regional and global financial systems, there is a need to avoid large distortions and an escalation of these forms of nationalism. This in turns calls for greater coordination across countries. Greater efforts to harmonise support measures across countries can help (re-)level the playing field, avoid major distortions, and thereby help restore competitive conditions. There is a need too for improved coordination when exiting from these interventions.

Except for arrangements in closely integrated regions, however, mechanisms with strong commitment are lacking. Much of this arises from the weak framework for regulating, supervising, and restructuring large cross-border financial institutions, which in turn leads to the excessive government support because of 'too big too fail' concerns. While the *ad hoc* and distorting interventions triggered by financial turmoil are unavoidable, and will continue in the short run; for the medium term, a new approach is necessary. I argue that an International Bank Charter (with dedicated regulator, lender of last resort, and deposit insur-

[1]The views expressed in this paper are the author's and do not necessarily represent those of the IMF or IMF policy. I would like to thank Richard Newfarmer and conference participants for their comments and Ezgi Ozturk for able research assistance.

ance and recapitalisation funds) specifically for large international active banks offers the best approach, possibly global, but at least on a regional basis. Only then is there scope for a concurrent, credible competition policy regime.

The structure of the paper is as follows. It first briefly reviews the causes of the financial crisis and the sources of cross-border spillovers, and the various government responses in advanced countries to date. The next section discusses the repercussions of the various interventions on competition, the policy issues, and the actions taken, and resulting effects on international competition. It sets the stage for the possible reforms regarding cross-border banking by reviewing financial reform options that will facilitate better competition policy. After quickly reviewing a first-best solution – a world financial regulator cum competition policy agency, it evaluates several other options for regulating and supervising large, complex, globally active financial institutions. It discusses the advantages and disadvantages of each from a competition point of view, stressing that options are difficult to rank. The last section concludes.

2. INTERNATIONAL DIMENSIONS OF THE CRISIS AND STATE OF AFFAIRS

I briefly review the causes of the crisis and the channels for its spreading, including the international spillovers, to help put interventions into perspective and make the solutions for competition policy address the deeper causes and not the symptoms. This will help identify those interventions with effects on other countries, some of which may have been anti-competitive. It will also help to identify the nature of international coordination issues and the need and scope for more general reforms.

2.1 Causes of the crisis

Although the debate on the relative importance will continue for some time, its various causes are well documented elsewhere (Calomiris, 2008). The causes concern both those common to past financial crises as well as new elements. The similarities include that the crisis was preceded by a period of high credit growth, rapid asset price appreciation, notably house prices, and accompanied by large capital flows to some countries. These patterns were not limited to just the United States, but also occurred in many other markets at the forefront of the crisis (United Kingdom, Iceland, Eastern Europe). And the build-up of risks occurred in a context of relatively benign global macro economic conditions, including low real interest rates.

Differences in this crisis include more opaqueness, and a greater (perceived) lack of information. Another new aspect is the greater financial complexity, and more interconnection among asset classes and parts of financial system, including increased international financial integration and a heightened importance of global financial players. Increased leverage of many financial institutions and much use of short-term and (or) wholesale funding sources, made liquidity more

pertinent to the evolution of the crisis. And, varying by market, specific weaknesses existed in regulation (for example, Structured Investment Vehicles (SIVs)), supervision (for example, mortgage markets at the US state level), conflict of interests (for example, at rating agencies), and incentives structures (for example, in the originate-and-distribute model). A different, yet common across many markets, element is the increased household sector debt and leverage, notably but not exclusively in housing.

2.2 Evolution of financial crisis and cross-border spillovers

As in any financial crisis, there have been, besides the underlying causes, triggers, and amplification mechanisms. While the crisis emerged in the US subprime, it quickly broadened to the larger US housing market and spilled over into other US financial markets (for example, other asset backed). Surprising was the degree and speed of global spillovers, which happened in several phases. The first phase was largely limited to banks with direct exposures to the US market and affected a few selected financial markets, sometimes related to liquidity runs. The second phase of international spillovers was transmitted through liquidity shortages, freezing of credit markets, and stock price declines, and affected many more markets, notably UK Sterling, Euro, and Swiss Franc. The third phase of international spillovers occurred in October 2008 through large solvency concerns affecting systemically important global financial institutions, leading to massive sell-offs, risking a (global) financial meltdown. The fourth phase of global spillover was, and continues to be, through the real sector consequences of economic slowdowns around the world, triggered in part by financial retrenchments and deleveraging.

2.3 Interventions triggered by the financial crisis

In the third phase, starting in the Fall of 2008 and ongoing, a number of advanced countries' governments intervened in their financial systems. As asset prices plunged across markets, the risks of cascading institutional failures and financial meltdown prompted authorities in a wide range of advanced countries to act in mid-October, marking an overdue transition from concerns about liquidity to solvency. The principal forms of intervention were: (i) liquidity provision through collateralised lending and other schemes; (ii) support for short-term wholesale funding markets; (iii) (more extensive) guarantees of retail deposits and other liabilities; (iv) purchases or exchanges of non-performing or illiquid assets; and (v) capital injections to banks.

The amounts involved with these interventions have been very large, and being based on already-announced commitments and past experiences, will increase further.[2] Table 15.1, for the G20 and a few other countries, shows that advanced

[2] There is a great difficulty identifying and classifying these interventions and the numbers should therefore be seen as an approximation.

Table 15.1: *Headline Support for the Financial Sector and Upfront Financing Need (As at April 15, 2009; in percent of 2008 GDP)*

	Capital Injection	Purchase of Assets and Lending by Treasury	Central Bank Support Provided with Treasury Backing	Liquidity Provision and Other Support by Central Bank [1]	Guarantees [2]	Total	**Upfront Government Financing [3]**
	(A)	(B)	(C)	(D)	(E)	(A+B+C+D+E)	
Advanced North America							
Canada	0.0	8.8	0.0	1.6	13.4	23.7	**8.8**
United States	3.9	1.3	1.1	42.1	31.3	79.6	**6.3** [4]
Advanced Europe							
Austria	5.3	0.0	0.0	0.0	30.0	35.3	**5.3**
Belgium	4.7	0.0	0.0	0.0	26.2	30.9	**4.7**
France	12	1.3	0.0	0.0	16.4	19.0	**1.5** [5]
Germany	3.8	0.4	0.0	0.0	18.0	22.2	**3.7**
Greece	2.1	3.3	0.0	0.0	62	11.6	**5.4**
Ireland	5.3	0.0	0.0	0.0	257	263	**5.3**
Italy	1.3	0.0	0.0	2.5	0.0	3.8	**1.3**
Netherlands	3.4	2.8	0.0	0.0	33.7	39.8	**6.2**
Norway	2.0	15.8	0.0	0.0	0.0	17.8	**15.8**
Portugal	2.4	0.0	0.0	0.0	12.0	14.4	**2.4**
Spain	0.0	4.6	0.0	0.0	18.3	22.8	**4.6**
Sweden	2.1	5.3	0.0	15.3	47.3	70.0	**5.8** [7]
Switzerland	1.1	0.0	0.0	10.9	0.0	12.1	**1.1**
United Kingdom	3.9	13.8	12.9	0.0	51.2	81.8	**20.2** [8]
Advanced Asia and Pasific							
Australia	0.0	0.7	0.0	0.0	N/A	0.7	**0.7**
Japan	2.4	11.3	0.0	1.2	7.3	22.1	**0.8** [9]
Korea	2.7	5.4	0.0	0.3	13.8	22.2	**0.4** [10]
Emerging Economies							
Argentina	0.0	0.9	0.0	0.0	0.0	0.9	**0.0** [11]
Brazil	0.0	0.0	0.0	1.5	0.0	1.5	**0.0**
China	0.5	0.0	0.0	0.0	0.0	0.5	**0.0** [12]
India	0.0	0.0	0.0	5.6	0.0	5.6	**0.0**
Indonesia	0.0	0.0	0.0	0.0	0.1	0.1	**0.1**
Hungary	1.1	0.0	0.0	4.7	1.1	6.9	**1.1**
Poland	0.4	0.0	0.0	0.0	3.2	3.6	**0.4**
Russia	0.3	0.5	3.2	3.2	0.5	7.7	**0.8** [14]
Saudi Arabia	0.6	0.6	0.0	8.2	N/A	9.4	**1.2**
Turkey	0.0	0.0	0.0	0.2	0.0	0.2	**0.0**
Average (PPP GDP Weights)							
G-20	1.9	2.5	1.0	12.4	14.3	32.1	**3.4**
G-20EU	2.7	3.8	3.2	0.5	22.1	32.3	**6.7**
Advanced Economies	2.9	4.0	1.3	18.8	22.8	49.8	**5.3**
Emerging Economies	02	0.1	0.4	1.6	0.1	2.4	**0.1**

Source: IMF, 2009 FAD-MCM database on public interventions. See the IMF Paper: 'The State of Public Finances', Chapter II for details.

1. This table includes operations of new special facilities designed to address the current crisis and does not include the operations of the regular liquidity facilities provided by central banks. Outstanding amounts under the latter have increased substantially, and their maturity has been lengthened in recent months in many cases.
2. Excludes deposit insurance provided by deposit insurance agencies.
3. This includes only those components of (A), (B) and (C) that require upfront government outlays.
4. Upfront financing is USD 900 billion (6.3 percent of GDP), consisting of TARP (700 billion) and GSE support (200 billion). Guarantees on housing GSEs are excluded. For details, see the IMF Companion Paper: 'The State of Public Finances', Chapter II.
5. Support to the country's strategic companies is recorded under 2; of which E14 billion Euro will be financed by a state-owned bank, Caisse des Depots and Consignations, not requiring upfront Treasury financing.
6. The amount in column (D) corresponds to the temporary swap of government securities held by the Bank of Italy for assets held by Italian banks. This operation is unrelated to the conduct of monetary policy which is the responsibility of the ECB.
7. A part of the capital injection (SEK50 billion) will be undertaken by the Stabilisation Fund.
8. Costs to nationalise Northern Rock and Bradford and Bingley recorded under (B), entail no upfront government financing.
9. Budget provides JPY 3900 billion to support capital injection by a special corporation and lending and purchase of commercial paper by policy-based financing institutions of the Bank of Japan.
10. KRW 76.7 trillion support for recapitalisation and purchase of assets needs upfront financing of KRW 3.5 trillion.
11. Direct lending to the agricultural and manufacturing sectors and consumer loans are likely to be financed through Anses, and would not require upfront government financing.
12. Capital injection is mostly financed by the Central Huijin Fund, and would not require upfront government financing.
13. Extensive intervention plans that are difficult to quantify have also been introduced recently.
14. Asset purchase will be financed from National Wealth Fund; and the government will inject 200 billion roubles to deposit insurance fund financed from the budget.

countries were most affected, while most emerging market countries included in the table have had less need for capital or other forms of financial sector support.[3] Especially liquidity provision and guarantees were large, amounting to double-digit fractions of GDP on average for the group of advanced countries. Capital support has been 2 percentage points and asset purchases 2.5 percentage points of corresponding GDPs. Besides the large direct fiscal costs, captured by the figures, there are many contingent costs, hard to quantify, such as the insurance schemes for assets or increased deposit insurance limits, and the implicit cost of a now generalised policy that large systemic financial institutions are not allowed to fail.

While these support amounts need to be scaled by the size of the problems, or at least by the size of respective financial systems, and while there are differences among countries in terms of the level and forms of support, there are no clear patterns. Also, while modalities for support have varied somewhat, the overall approaches are largely similar. This similarity reflects to a significant degree the fact that countries were forced to adopt measures because of beggar thy

[3] A number of other emerging markets have had to extend large support to their financial sectors (and have faced balance-of-payments crises). IMF 2009b provides more details for a larger set of countries.

neighbour effects. The spillovers, for example, from the guarantee in Ireland were large and happened rapidly, forcing countries to adopt similar policy in a matter of a few weeks. And the recapitalisation and other support approaches became loosely based on what can be called the UK approach. These beggar-thy-neighbour effects were the more perverse since the individual country systemic bank restructurings were not first best to begin with, as often is the case in times of intense financial turmoil (Claessens et al. 2003). This in turn meant many 'lowest common denominator' effects.

2.4 National effects

The interventions have generally had the aimed-for effects, namely stabilising financial systems and regaining some measure of confidence in the system. By nature however, these measures are very distorting, directly – as they support financial institutions in non-market ways, or indirectly – as they can skew and distort resource allocation. A clear example of the (purposely) distorting nature in financial intermediation is intervention by central banks, notably the US Federal Reserve, in a number of (short-term) markets, either directly (for example, through the purchases of government bonds) or indirectly (for example, through the various liquidity facilities which aim to support specific financial markets, such as the commercial paper market). And the guarantees for new bank liabilities distort the (interbank) markets.

Another financial intermediation example is the provision of a guarantee scheme for money market funds in the United States following the large outflows after one fund 'broke the buck' (its net asset value fell below one dollar, that is,, below par). The guarantee in turn led to deposit outflows at commercial banks, which prompted an increase in deposit insurance coverage. A clear example of the distortions introduced by the extension of guarantees is the case of Ireland. Prior to the extension of guarantees to the largest size banks, the Credit Default Swap (CDS)-spreads for the large Irish commercial banks were very high. Post guarantees, bank CDS-spreads declined sharply. At the same time, the sovereign spread sharply increased. Measures like these, now numerous in many advanced countries today, distort asset prices and financial flows.

The indirect distortions affecting the real sector are more difficult to document, but there are many programs that provide suggestive examples. In many countries, programs have been put in place to support more lending to small- and medium-sized enterprises (SMEs). But also large firms have been targeted for public support. In Japan, for example, in April 2009, parliament passed a law to allow for the recapitalisation of (larger) non-financial firms using public funds through preferred share purchase by the (state-owned) Development Bank of Japan.[4] In the United States, France, and Italy car companies are being (indirectly) supported. In several countries, there were (largely informal) requirements

[4] The main eligibility criteria are (i) firms that employ more than 5000 people; (ii) firms whose sales contract more than 20 percent within one quarter or 15 percent within half year.

for local lending as part of financial sector support. All of this has, directly and indirectly, affected international competition in various markets, financial and real (for example, inefficient zombie firms may be created, driving out efficient firms).

Furthermore, the increased direct state-ownership and the large indirect roles of the state in the financial sector risk distorting financial intermediation in a deeper and potentially longer-lasting way. The perverse (long-term) consequences of state-owned banks are well documented and, while in most countries good institutional environments should prevent the worst effects, distorted outcomes may still arise. In addition, there are many other (sometimes-unintended) consequences of the interventions. One such in the United States is the effect of caps on remuneration, which is affecting incentives, not only of those financial institutions now supported through public funds but also of others. These types of rules, and the more general larger role of the state, can affect the quality of financial intermediation.

2.5 International effects

While the large government interventions were necessary and often unavoidable, they have led to unintended effects on other countries, creating large distortions in international capital flows and financial intermediation in the short term. Liquidity support provided the first manifestation. Actions in the United States initially focused on providing domestic support, even though interbank market prices suggested significant dollar funding pressures for European banks and emerging markets. For mature markets, it took several weeks to act on these stresses. And, even after *ad hoc* bilateral swap lines between central banks were set up and their scope gradually increased, market prices continued to suggest that problems remained. The response was slower and amounts provided more limited in the case of emerging markets, even though problems existed as well. With US dollar central bank swap lines provided only to a handful of countries, liquidity shortages were keenly felt by many emerging markets. Large external financial support from various sources has been necessary for several emerging markets hit by deleveraging process, but the real consequences had already been incurred.

Guarantees on deposits and other liabilities issued by individual countries provide another example. These have led to beggar-thy-neighbour effects as, starting with Ireland, they forced other countries to follow with similar measures. Some advanced countries, especially those closely integrated (such as the European Union/European Monetary Union) quickly coordinated policies, for example, adopted uniform minimum deposit guarantee coverage. The rapid spread of guarantees led to further financial turmoil in other markets. Many emerging markets not able to match guarantees suffered from capital outflows and large currency depreciations as investors sought safe havens. Distribution of risks sharply changed over time and across circumstances. The CDS spreads for many banks, for example, fell as governments provided guarantees, while many sovereign CDS

spreads increased. Furthermore, policy measures aiming to encourage lending often had a bias toward local lending, putting international operations at a disadvantage.

Countries were also quick to 'ring-fence' assets in their jurisdictions when cross-border entities showed signs of failing, reflecting the absence of clear burden-sharing mechanisms for banks with international operations. Prominent examples of defensive 'asset grabs' were: the decision by UK supervisors, fearing an imminent collapse of Icelandic bank branches (under the authority of Icelandic supervisors, who did not provide a commitment to fulfil UK bank liabilities), to resort to the *Anti-terrorism, Crime and Security Act* to ring-fence Icelandic bank assets within the United Kingdom; and the German initiative to freeze Lehman's assets to assure the availability of cash to satisfy depositors, before they could be attached to the parent under US bankruptcy proceedings. Such actions constituted in part also anti-competitive behaviour, in that they tended to favour local interests.

Most government interventions to date have been at national levels. Although there were some coordinated actions (for example, those among Belgium, Netherlands and Luxembourg, and with some involvement of France, to resolve Dexia and Fortis), these largely remained driven by purely national interests (as suggested by the fact that the intervened entities were often broken up along national markets, and in line with support). The main exception was the coordinated (although only after some serious disruptions) provision of liquidity support. And, in the Euro-area, central bank actions are, by design, (nearly) fully coordinated among Eurosystem members.[5]

2.6 Current state and short- and medium-term international repercussions

While the relatively comprehensive actions over the last half year have provided some sense of stability, the crisis is still evolving, with rapid slowdowns spreading through financial and economic channels. Continued turmoil means extraordinary government interventions will continue and the (international) rules of the game will remain in flux. The coverage and scope of interventions and other policy measures will evolve, depending on effectiveness and conditions, and support amounts will likely increase further. As circumstances evolve, governments will (need to) adjust the rules, such as how to treat shareholders and creditors when restructuring large financial institutions, creating further uncertainty. If political support diminishes, support may become (even) more nationally oriented and distortions will increase further.

While risks remain, it is also generally agreed that distortions should be removed as quickly as possible to return to a sustainable system in line with a new financial architecture. As the crisis abates, governments need to plan for exit also, given fiscal constraints. These are difficult, and largely unprecedented processes, especially so in the context of highly integrated financial systems. It

[5] Some minor differences still exist among members, for example, in the registration of collateral.

is clear, however, that lack of coordination can create (new) distortions. If the unwinding of interventions is not coordinated internationally, it can aggravate still weak confidence, create new distortions, and potentially be anti-competitive. Especially for the removal of guarantees, governments would do well to coordinate to avoid large capital movements. Yet, while more coordination would be desirable, in practice it is difficult.

3. STATE INTERVENTION AND COMPETITION: ISSUES, APPROACHES AND OPTIONS

Before analysing the effects of state intervention, it is important to review the general conceptual and empirical issues related to competition in the financial sector. I then consider how state intervention can hurt, but also enhance competition, different from that in other sectors (see also OECD 2009 and EU 2009).

3.1 Competition in the financial sector: general issues

When considering the effects of state interventions, it is important to keep in mind that the issue of competition in the financial sector is quite complicated and different from that in many other sectors. Because of network externalities, sunk costs, economies of scale and scope, switching costs, substitution and complementarity among financial services, etc., standard principles of competition (policy) do not easily apply to financial services provision. This in turn means that measures such as market structure do not easily map into a degree of competition (for a review, see Claessens 2009).

Because of these methodological challenges, combined with lack of adequate data, the degree of competition is hard to determine empirically in the financial sector. When attempts have been made to measure the degree of competition properly, a few regularities have been found, notably the degree of contestability, the (perverse) effects of state-owned banks, and the beneficial effects of foreign banks entering markets. But much remains unknown on what drives competition, especially in a dynamic context, and the gains and costs of greater competition.[6]

Furthermore, a link has often been made between competition and financial stability in the conduct of (prudential) regulation and supervision. Whether this link exists and for what reasons, however, is debatable.[7] Nevertheless, this view has affected policy making and still does so. More generally, finance can suffer

[6] For example, financial institutions create natural entry barriers by investing in technology so as to process and overcome information asymmetries better. This in turn has effects on competition, but also on consumer welfare that can be at odds with (static) competition.

[7] For one, conceptually it is not obvious that greater competition leads to instability, either in a static or dynamic sense. Financial intermediation may benefits from new technology spurred by competition, since it allows for greater risk sharing. And empirically, evidence on the link has indeed been found both ways. Second, it is not obvious that restricting competition is the first-best way to reduce instability; rather, prudential regulation and supervision should be used.

from many market failures, calling, at least in theory, for extensive government interventions.

3.2 State intervention for systemic reasons and competition: conceptual issues

The complexity, stability, and market failures elements should affect how one considers the effects of any public policy, including forms of state intervention in financial crises, on (international) financial sector competition. During times of financial turmoil and crises, coordination failures and adverse impact of a failing financial system on the real economy justifiably call for government interventions. While few doubt the need for government intervention, (continued) interventions do create distortions, not only domestically but also across borders, leading to various competition effects (see Fingleton, 2009; Lyons, 2009; and Vickers, 2008 for recent reviews). What does support mean for competitive conditions? What is the balance between support and competition? Does support lead to, besides weaker market discipline, unfair competition or can it actually enhance competition? Does it vary by forms of government support, by circumstances? Are there ways to mitigate potential anti-competitiveness effects?

On the positive side, support for individual financial institutions especially those that are systemic can have beneficial effects on other financial institutions, and thereby on competition. This is because those financial institutions that themselves are not systemic can benefit, as otherwise they could have risked insolvency. Since these non-systemic financial institutions may be important to overall competition – perhaps more so than the systemic financial institutions themselves, intervention during this period can help with competition, in the short run but especially in longer run. This is also so at the international level: support from one state for banks in its jurisdictions can enhance other countries' financial systems and overall international financial system's stability. It could thereby lead to better preconditions for competition internationally. Whether it does, depends in part on how the support is being provided across financial institutions and markets.

As noted, most of the support measures did not start from a deliberate government policy and were adopted in the middle of the crisis, with little time for consultation nationally, let alone internationally. Nevertheless, as the crisis progressed and countries subsequently adopted support measures, a greater commonality among measures materialised – in part as countries faced being left behind in the various dimensions. This was reinforced by attempts by some international agencies and groups to harmonise various interventions to re-establish a level playing field. The overall general principles behind these attempts are similar. More extended retail guarantees need to cover all deposits uniformly within a jurisdiction, and preferably across jurisdictions. This is especially critical where financial markets are closely integrated. Also, guarantees for interbank lending, bond issues, and other wholesale funding have to be clearly stated and be available for all financial institutions. Capital injections should bring capital up to recognised standards at all institutions (with buffers for future losses), as

undercapitalised institutions may undermine competition. And general programs for purchasing assets should not discriminate between institutions or nationality.

The premise underlying these principles is presumably that, as long as these interventions are applied to all (national) financial institutions and all forms of financial intermediation equally, there need not be negative consequences for competition. This is not necessarily so however. Solvent financial institutions, for example, do not benefit (as much) from guarantees. At the same time, these interventions, in part as they are anticipated, condition market behaviour. This happens not only through the channel of moral hazard, which relates to excessive risk-taking of inefficiencies at the individual institution level, but also affects markets' general conduct, since not necessarily the least-efficient firms exit and the best survive, and creative destruction is suppressed.

As such, even when applied evenly, interventions in times of financial stress can have overall negative effects on competition. Furthermore, political economy issues are important to consider. In practice, financial sector regulations and interventions are not always aimed at first best outcomes – the influences of political economy and vested interests are especially large in finance, even in advanced countries. As such, separating good from bad regulations and interventions can be very hard, and the premise may have to be that a more liberalised financial system with little state intervention is closest to first best, even in financial crises.[8]

3.3 Competition approaches regarding the impact of state interventions and coordination attempts

As the various support measures for individual financial institutions attracted much attention of regional and international organisations, they have led to actions to reduce their distorting impact. The competitiveness impacts of specific cases have been most discussed in the context of the European Union, not surprising given on the one hand its tight financial integration and extensive cross-border financial services provision, and on the other hand the existence of an institutional environment for formally investigating competition policy issues – the Directorate General (DG) for Competition. The EU view on aid to the financial sector has been phrased as follows (open letter of the DG to the Financial Times, April 22, 2009): "We are applying the tried and tested code of good economic governance that the EC Treaty's state aid rules represent to ensure four things: 1) that banks receive sufficient support to avoid financial meltdown; 2) that Member States' cures for their own banks do not put those banks in an artificially advantageous competitive position that would kill off banks in other Member States; 3) that banks are restructured to ensure their future long-term viability so that the mistakes of the past are not repeated, that taxpayers' money

[8] Clearly, opinions vary with, some observers seeing the financial crisis as due to massive government failures, including moral hazard, and others seeing it as a combination of market failures, with obviously very different policy implications.

does not disappear down a black hole and that lending to the real economy is secured; 4) that the Single Market is preserved, with no discriminatory conditions attached to aid and no barriers to entry for cross-border banking. This is because the Single Market is crucial to ensuring Europe's economic recovery".

Reflective of this view, and triggered by the many state interventions, the European Commission has issued a number of communications aimed at both forcing similarity in interventions among countries and inducing practices that are closer to market principles.[9] These communications, for example, state that government guarantees for new bank borrowings need to be priced in line with the currency-specific risk-free rate plus a spread related to the CDS spread for the particular bank in the period before the financial crisis. Another communication states that capital injections need to carry yields that relate as well to the safe interest rate and the risks involved (for example, whether it involves common or preferred equity). These and other communications, such as on deposit insurance, have reduced some of the intra-EU distortions.

The WTO has also made some statements on the effects of the financial crisis on competition (WTO, 2009). And the G20 adopted in its two communiqués broad language to indicate that its members are committed to prevent financial protectionism, albeit it has not adopted any further specific guidelines. While these rulings will help to reduce of some of the distortions, however, by nature they remain imperfect.

3.4 Decisions regarding state specific interventions

The DG for Competition Policy has also made decisions on 49 specific cases (until the end of April 2009). In some cases, it has asked for financial measures. In only a few cases, has it asked for some operational restructuring conditions, such as a spin-off of branches, specific units, or other actions. In most cases, however, it has not taken any action; that is, it has allowed the state aid or intervention to continue as proposed.[10] The fact that there were often no 'actions' decisions does not necessarily mean that the European Commission judged that there were no, general or specific, anti-competitive implications. Rather, the judgment might have been that these possible anti-competitive effects were necessary, given the risks of economic and financial consequences of not intervening at a time of financial turmoil.

This no-action choice is somewhat akin to the balance of payments exception in the *General Agreement on Trade in Service* (GATS). GATS explicitly includes a balance of payments safeguard that allows the member to impose temporary re-

[9] See EU (2008), and EU (2009a; 2009b; 2009c). Note further that there already existed EU rules aimed at avoiding distortions from state interventions. For example, EU (2004). See also Rossi and Sansonetii (2007).

[10] Obviously, there would have been a back and forth between the various interested parties – financial institutions and government – with the Commission before a decision was announced. As such, the terms are likely to have been adjusted prior to the decision if the Commission had objections.

strictions that suspend its commitments – on a non-discriminatory basis – in the event of 'serious balance-of-payments and external financial difficulties or the threat thereof'. Indeed, the Commission's general approach to government support as stated above is consistent with this.

3.5 Evaluation of competition policy approaches

The need to balance these various objectives is repeated in the rulings and statements made by the DG or individuals from the DG (for example, Neven, 2009). It suggests that direct effects of state aid on competition have played less of a role in its rulings. And to the extent that competition was a key question for the EC-DG, the effect on intra-EU competition, not on local competition is what has occupied it, consistent with its mandate.

Nevertheless, the EC-DG decisions have been critiqued, by private market participants, academics, and public sector officials. The former is not surprising, as some have obviously been adversely affected by decisions. The academics' views have varied (for example, Vives 2009). The criticisms from the public sector have (obviously) been more muted. Nevertheless some (for example, Bundesbank President Axel Weber, as reported by Atkins, 2009) have judged that the EC-DG requirements for state-supported financial institutions have had a bias towards hiving off financial institutions' international, cross-border but intra-EU operations, thereby undermining the objective of creating a single market in the European Union. This has led to some further reactions (for example, Stark, 2009).

A final judgment on the international competition impact of the various state interventions is hard to make and will have to await some further analysis. The premise nevertheless is that these state interventions have reinforced the position of those incumbents that already had favoured (national) preferences. As such, although unavoidable, the interventions have been anti-competitive. Going forward to avoid these outcomes, a method has to be found that allows competition policy to be conducted with less regard for systemic stability. In the interim, measures to harmonise the rules for state support and level the playing field can serve a useful role, even though they do not eliminate many of the anti-competitive effects of the interventions.

4. BROADER PROBLEMS OF CROSS-BORDER BANKING

The various interventions have raised many international competition issues (the national issues are not discussed here, even although many are obviously similar).[11] Some of the international competition issues relate to the still poorly developed rules and mechanisms for dealing with large financial institutions whose activities span many markets and activities. The crisis has made even clearer the

[11] In the United Kingdom, the Office of Fair Trading has issued opinions in a few cases, such as in the context of the Lloyds takeover of HBOS, but these were subsequently found to be overruled by the public interest of systemic stability (see Vickers 2008 and Lyons 2009 for discussions).

lack of sound mechanisms to deal with these institutions. This is most evident in the resolution of global banks headquartered in relatively small countries, but with balance sheets that can exceed their home-country's GDP (as is the case for Belgium, Hong Kong, Iceland, Luxembourg, the Netherlands, Switzerland, and the United Kingdom, a few countries in that position). Few single countries can deal with such institutions on their own, yet they affect many markets. But the tension also exists for banks that are relatively smaller as (authorities in) countries have preferences for national champions, which end up distorting *ex ante* and *ex post*. And coordination issues arise in general with regard to cross-border banking, with Central and Eastern Europe a clear current case in point.[12]

Clearly, in this crisis, and even more so in the future – as financial institutions may keep getting larger – and more complex, a better method has to be found to handle these institutions. Solutions have to be found in a broad reform of the international financial architecture, which is a large agenda with many public good aspects. It also importantly depends on other, more national-oriented financial sector reforms currently being discussed (for an overview of needed financial reforms see IMF, 2009a). This need for reforms has long been acknowledged in an international context, and specifically in the context of European Union's and even more so, the Euro's closely integrated financial markets.

Reforms underway include greater convergence in financial sector regulation and supervision practices across countries. The major international standards (such as Basel II) are already attempts to create greater uniformity in rules, especially for international active banks. And the Financial Sector Assessment Program of the World Bank and IMF is a means to check the implementation of rules and the adequacy of practices, and thus assure greater convergence in practices. These reforms will help reduce coordination problems and create a more level playing field. These general issues will not be discussed here; what will be discussed are the current approaches to cross-border banks and some specific solutions needed to deal with large cross-border banks, given their externalities and adverse competitive effects during times of financial stress under the current system.

4.1 Cross-border activities: current approaches

The current approach is largely based on the 'home-host' principle which says that home countries have to supervise the branches and subsidiaries of their banks in foreign countries (see Basle Committee on Banking Supervision, BCBS, 2006). Yet, many, including BCBS itself, have recognised that this principle is not suf-

[12] Banks in Western Europe are at risk due to their exposure in Eastern Europe, much of it in the form of wholly owned subsidiaries. Exposures are very large, for example, lending by Austrian banks to Central and Eastern Europe amounts to 80 percent of its GDP. Given strong interbank linkages within Western Europe, defaults of a limited number of banks would have strong domino effects across a wide range of countries. Yet, coordinated solutions appear very difficult to organise. For example, calls for pan-European recapitalisation funds have repeatedly been rejected in recent months. In the meantime, emerging markets in Eastern Europe are under siege, as it is not clear that local subsidiaries of foreign banks will be fully supported.

ficient, particularly in the light of rapid internationalisation. Fundamentally, a foreign subsidiary of a major international bank may be significant in the market in which it operates, but be of little significance for the banking group as a whole. Conversely, a subsidiary that is significant for a banking group may not be significant for a host country, for example, if it is located in a major financial centre. Potential conflicts also exist in terms of management within the bank or group. These differences in interests can adversely affect host and home markets, and thereby overall international financial stability and competition.

The convergence process will remove some of these conflicts of interests. There will remain, however, severe economic, legal, political, and other limits to convergence in rules and practices (see Caprio et al. 2006, for a collection of papers on this topic). Similarly, while many improvements are possible to the home-host principle – and some are being implemented, these will in practice be fraught with significant limitations, especially for relatively large local entities in host markets. And it remains the case, similar to within a domestic context, that many of the precise channels through which international spillovers and contagion occur are not always well understood.

4.2 Possible other options

As such, it is likely that international financial instability will continue to trigger *ad hoc* government interventions. In essence, the problem of interventions boils down to coordination problems. There is both limited *ex ante* coordination in dealing with cross-border financial institutions and there are poor mechanisms for burden sharing *ex post*, when cross-border institutions risk failing.[13] Various solutions have been proposed over the years, each with its own advantages and problems. They vary from centralisation, a new regime, and enhanced coordination, to increased convergence in rules and practices.

5. WORLD FINANCIAL AUTHORITY

The very first best would be an international financial regulator, perhaps called a World Financial Authority (WFA) that would regulate and supervise all, or at least all large financial institutions. This was perhaps first proposed by Eatwell and Taylor in 1998, and it has an analogue to the World Trade Organization (WTO).[14] It is the obvious solution to any coordination issues, and thus reduces the anti-competitive effects of *ad hoc* government interventions during financial crises. It could also be complemented by greater powers of the WTO on competition in the financial sector and trade in financial services.

[13] While poor regulation and supervision also give rise to negative externalities, these are not the subject of discussion here. To some extent these can be addressed through the various convergence processes (standards, FSAP, regional integration). And, while imperfect, countries do have the option to exclude financial institutions from some countries from their own markets on prudential grounds.

[14] The idea was first mentioned in a working paper of 1998, and then published in their book of 2000.

At the same time, this model is very demanding if it is to be fully consistent in all dimensions. The international financial regulator would need to be complemented by lender of last resort liquidity facilities, an international deposit insurance, and a recapitalisation fund, similar to the requirements in a domestic context (see Boot 2006 for the EU case). This WFA would also be difficult to govern, as its objectives would be hard to establish. And it is unlikely to materialise in the near future. The experiences of the European Union suggest that, even after moving towards very close financial, economic, and political integration, adopting a common, single, regulatory and supervisory authority is very hard.

Three other solutions, not first best, but perhaps second or third best, are: an international bank charter, increased harmonisation in rules and convergence in practices without increased coordination, and increased coordination with less or no harmonisation or convergence.

6. INTERNATIONAL BANK CHARTER

One approach closely related to the first best, but perhaps more feasible in the medium term, is to establish a separate regime for large, internationally active financial institutions, with some elements of voluntarism. Under this 'International Bank Charter' (IBC) model international active banks would only be globally chartered and under the supervision of a single regulator. The European bank charter that was proposed some time ago (Cihak and Decressin, 2007; see also Decressin et al., 2007), and possibly similar charters, could be the equivalent of this on a regional basis.[15]

Under this model, there would also be an international regulatory and supervisory body. The set of actions available to this body would again be the regular licensing, regulatory, and intervention tools of any national financial regulator. Complementary measures needed are again common liquidity support and lender of last resort facility, shared intervention resources with fiscal backup, and an International Deposit Insurance Corporation, perhaps supplemented by a recapitalisation fund, both receiving fees from the banks. The IBC banks could operate around the world (or at least in sponsoring countries) without any further permission, regulations, or needs for reporting and compliance.[16] This model would avoid the messy constellation of home and host supervision. Importantly, it assures coordinated actions, especially of those actions aimed at containing and

[15] Technically, European banks can already establish themselves as a European Company ('Societas Europaea'), but there would not be a corresponding shift in regulation and supervision.

[16] One key issue is the degree of 'voluntarisms': should international banks be allowed to choose themselves, or should they be forced to be subject to the international regime? Obviously there can be adverse selection here: weaker banks may not be interested in subjecting themselves to, presumably, a stronger international regime. Required participation may therefore be the better approach. But then there need to be clear and common criteria, say banks above a certain cut-off in terms of size of international operations (although that may not be a sufficient criterion, since, especially in times of financial turmoil, even small banks can have negative externalities).

resolving a crisis. With coordination assured, *ad hoc* and distorting interventions by governments would be avoided, and a more competitive landscape would result.

7. DECENTRALISED, BUT CONVERGED APPROACHES

One 'third' best could be a decentralised approach, that is,, where actions are not coordinated, but frameworks are adapted, with the expectation to mimic outcomes similar to those under a first or second best regime. This would at the minimum involve more convergence in five areas (see further Financial Stability Forum, 2009). First, the rules and regulations governing international active banks. Second, clarity on who will supervise what aspects of international banks with, in particular, the coverage of branches and subsidiaries and treatment regarding off-shore financial centres to be clarified. Third, consistency in the rules for lender of last resort, liquidity support, deposit insurance and other forms of safety net. Fourth, internationally consistent resolution regimes (for example, foreign creditors should be treated equivalently to domestic counterparts, collateral security to be recognised across legal jurisdictions, modalities for (prompt) corrective action, including areas such as the scope and threshold of public intervention, especially for large, complex cross-border financial institutions). Fifth, *ex ante* agreed upon rules on burden sharing and resolution in case of failures that require bailouts or payout, including more common recovery procedures for impaired assets and uniform approaches regarding state ownership in intervened institutions.

Common rules alone will not be enough as differences in practices can still arise, in part because of competition among regulators (Dell'Ariccia and Marquez, 2006). Participation by many countries in rulemaking will increase legitimacy and facilitate the enforcement of rules. Practices, however, still need to be assessed. The existing apparatus for assessing policy implementation (such as FSAPs) need to be sharpened and procedures improved, their voluntary nature reassessed, and modalities for raising concerns clarified.

In principle, this could reduce many of the current problems, create a more level playing field, and thereby improve competitive conditions. It will not be enough to mimic the first best solution, however, since it does not consider the many externalities at the international level (Schinasi, 2005). Just as proper regulation and supervision of individual financial institutions does not guarantee systemic stability, similarly (proper) national regulation and supervision do not guarantee international financial stability and efficiency. Coordination issues at the international level, both among private sector participants and between national authorities, are simply too plentiful. The key for this model to work is probably that the *ex ante* agreed rules on burden sharing are binding *ex post*, very hard obviously (Freixas, 2003; see also Goodhart and Schoenmaker, 2006). As such, the model will not easily assure a fully competitive, level-playing field among countries.

8. ENHANCED COORDINATION, INCLUDING COLLEGES

Another, substitution or complementary model is to rely on more coordination of actions, even in the absence of (further) convergence of rules. This is the model, for example, for the European Union as laid out in the most recent De Larosière (2009) report. Under this model, some body would have the power to legally binding mediation between national supervisors, adopt binding technical decisions in regard to specific financial institutions, and play a strong coordinating role, especially in financial crises. When backed up by appropriate legal changes, this structure could presumably overcome many of the *ex post* coordination issues, even in the presence of national structures and rules that are still quite different.

The current approach of adopting a supervisory college for large financial institutions (now 28) is a decentralised form of this model, albeit with its own limitations, such as limits on information sharing (due to confidentiality, but also pure power plays). Importantly, since colleges are designed to concern themselves only with individual financial institutions, they will not explicitly consider overall international financial system stability. The risks may be, however, that these measures create a false sense of security, with the possibility of financial crises remaining.

9. CONCLUSION

The state interventions necessitated by the financial crisis have led to many and massive distortions, directly – as they support financial intermediaries in non-market ways, and indirectly – as they can distort financial intermediation and resource allocation. Measures also have had international repercussions, most notably when governments extend guarantees to financial intermediaries – that distort capital flows, and through capital and other support measures – that often favour national institutions and have a bias towards local lending.

Implications for competition are not obvious, however. Competition in the financial sector is a complex issue. And support during financial stress periods can enhance competition as it avoids the elimination of (non-systemic) institutions essential to contestability. Efforts to harmonise support measures across countries can help level the playing field, avoid major distortions, and thereby help maintain competitive conditions. But these remain imperfect as *de facto* weaker financial institutions will be supported, thus undermining market principles.

Nevertheless, and given the tightly integrated global financial system, there is a greater need for cooperation and coordination across countries to avoid large distortions and an escalation of these forms of nationalisms. There also is a need for coordination when exiting from these interventions. Except for arrangements in closely integrated regions, however, global mechanisms with strong commitment are lacking. While unavoidable in the short run, for the medium term, a new approach is necessary to avoid the *ad hoc* and distorting interventions. There is especially a need for improved mechanisms to deal with cross-border banks and

other large financial institutions, which few single countries can deal with on their own, yet they affect many markets which keep getting larger and more complex.

To address this, I present a number of options. A first-best approach – called a world financial regulator – is unlikely to be attainable in the short run. I argue that an International Bank Charter (with dedicated regulator, lender of last resort, and deposit insurance and recapitalisation funds) specifically for large international active banks offers the second-best approach. Other options – such as increased convergence in rules and policies and enhanced coordination in actions – are obviously difficult to rank. But, over the medium term, any of these approaches can help with assuring competitive conditions, even in times of financial stress.

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16

Crisis and Protection in the Automotive Industry: A Global Value Chain Perspective

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1. GLOBAL VALUE CHAINS IN THE AUTOMOTIVE INDUSTRY: A NESTED STRUCTURE

From a geographic point of view, the world automotive industry, like many others, is in the midst of a profound transition. Since the mid-1980s, it has been shifting from a series of discrete national industries to a more integrated global industry. In the automotive industry, these global ties have been accompanied by strong regional patterns at the operational level (Lung et al, 2004; Dicken, 2005; 2007). Market saturation, high levels of motorisation, and political pressures on automakers to 'build where they sell' have encouraged the dispersion of final assembly, which now takes place in many more places than it did 30 years ago. While seven countries accounted for about 80 per cent of world production in 1975, 11 countries accounted for the same share in 2005 (Automotive News Market Data Books, various years). The widespread expectation that the markets in China and India were poised for explosive growth generated a surge of new investment in these countries. The recent economic crisis is serving to reinforce and accelerate many of these trends.

Consumer preferences sometimes require automakers to alter the design of their vehicles to fit the characteristics of specific markets.[1] In other places, automakers want their conceptual designers to be close to 'tuners' to see how they modify their production vehicles. These motivations have led automakers to establish a series of affiliated design centres in places such as China and Southern California. Nevertheless, the heavy engineering work of vehicle development, where conceptual designs are translated into the parts and sub-systems that can be produced by suppliers and assembled into a driveable vehicle, remain cen-

[1] Examples include right- versus left-hand drive, more rugged suspension, and larger gas tanks for developing countries, and consumer preferences for pick-up trucks in Thailand, Australia, and the United States.

tralised in or near the design clusters that have arisen near the headquarters of lead firms.[2]

The automotive industry is therefore neither fully global, consisting of a set of linked, specialised clusters, nor is it tied to the narrow geography of nation states or specific localities, as is the case for some cultural or service industries. Global integration has proceeded at the level of design and vehicle development, as firms have sought to leverage engineering effort across products sold in multiple end markets. As suppliers have taken on a larger role in design, they in turn have established their own design centres close to those of their major customers to facilitate collaboration.

On the production side, the dominant trend is regional integration, a pattern that has been intensifying since the mid-1980s for both political and technical reasons. In North America, South America, Europe, Southern Africa, and Asia, regional parts production tends to feed final assembly plants producing largely for regional markets. Political pressure for local production has driven automakers to set up final assembly plants in many of the major established market areas and in the largest emerging market countries, such as Brazil, India, and China. Increasingly, lead firms demand that their largest suppliers have a global presence as a precondition to be considered for a new part. Because centrally designed vehicles are manufactured in multiple regions, buyer-supplier relationships typically span multiple production regions.

Within regions, there is a gradual investment shift toward locations with lower operating costs: the Southern United States and Mexico in North America; Spain and Eastern Europe in Europe; and South East Asia and China in Asia. Ironically, perhaps, it is primarily local firms that take advantage of such cost-cutting investments within regions (for example, the investments of Ford, GM, and Chrysler in Mexico; and Volkswagen and Peugeot in Eastern Europe), since the political pressure that drives inward investment is only relieved when jobs are created within the largest target markets (for example, Japanese automaker investments in North America and Europe have been concentrated in the United States, Canada, and Western Europe). Automotive parts, of course, are more heavily traded between regions than are finished vehicles. Within countries, automotive production and employment are typically clustered in one or a few industrial regions. In some cases these clusters specialise in specific aspects of the business, such as vehicle design, final assembly, or the manufacture of parts that share a common characteristic, such as electronic content or labour intensity. Because of deep investments in capital equipment and skills, regional automotive clusters tend to be very long-lived.

To sum up the complex economic geography of the automotive industry, we can say that global integration has proceeded the farthest at the level of buyer-sup-

[2] The principal automotive design centres in the world are in Detroit, US (GM, Ford, and Chrysler, and more recently Toyota and Nissan); Cologne (Ford Europe), Rüsselsheim (Opel, GM's European division), Wolfsburg (Volkswagen), and Stuttgart, Germany (Daimler-Benz); Paris, France (Renault); and Tokyo (Nissan and Honda) and Nagoya, Japan (Toyota).

plier relationships, especially between automakers and their largest suppliers. Production tends to be organised regionally or nationally, with bulky, heavy, and model-specific parts-production concentrated close to final assembly plants to assure timely delivery (for example, engines, transmission, seats and other interior parts), and lighter, more generic parts produced at a distance to take advantage of scale economies and low labour costs (for example, tyres, batteries, wire harnesses). Vehicle development is concentrated in a few design centres. As a result, local, national, and regional value chains in the automotive industry are 'nested' within the global organisational structures and business relationships of the largest firms, as depicted in Figure 16.1

2. THE OUTSOURCING BOOM AND RISE OF THE GLOBAL SUPPLIER

One of the main drivers of global integration has been the consolidation and globalisation of the supply base. In the past, multinational firms either exported parts to offshore affiliates or relied on local suppliers in each location, but today *global suppliers* have emerged in a range of industries, including motor vehicles (Sturgeon and Lester, 2004). Since the mid-1980s and through the 1990s, suppliers took on a much larger role in the industry, often making radical leaps in competence and spatial coverage through the acquisition of firms with complementary assets and geographies. This trend has been most pronounced among

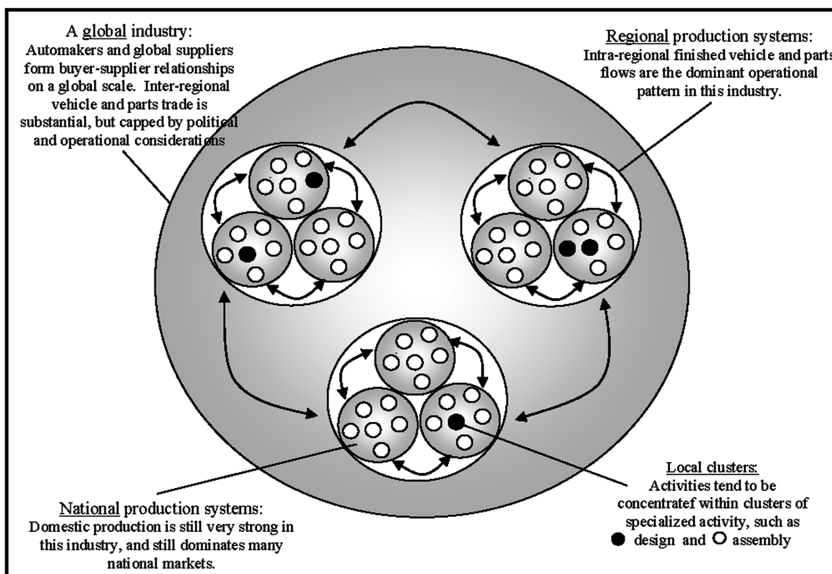

Figure 16.1: *The Nested Geographic and Organisational Structure of the Automotive Industry*

US-based suppliers. Figure 16.2, which traces the history of parts and assembly employment in the United States from 1958 through 2002, clearly shows this structural shift. Until 1985, parts and assembly employment were roughly equal. After 1985, employment shifted into the supply base as automakers made fewer sub-assemblies such as cockpit assemblies, rolling chassis, and seats in-house, purchasing them instead from outside suppliers. This drove rapid growth among the largest suppliers as well as consolidation, as firms engaged in mergers and acquisitions to gain the capability to make larger and more complex sub-systems. At the end of the 1990s, GM and Ford fully embraced the outsourcing trend by spinning off their respective internal parts divisions, creating what were at the time the world's two largest automotive parts suppliers, Delphi and Visteon. Because they were spun out of huge parent firms with strong international operations, these 'new' suppliers were born with a global footprint and the capability to supply complete automotive subsystems.[3]

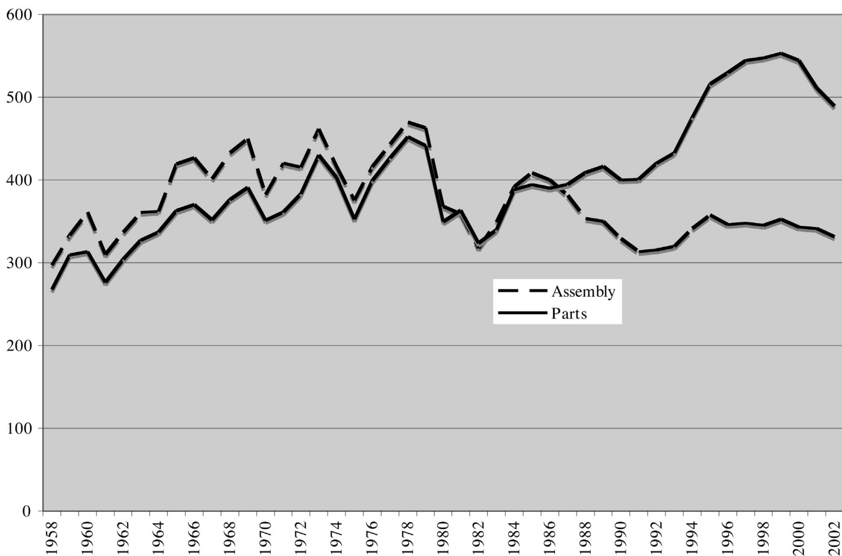

Figure 16.2: *Outsourcing in the US Automotive Industry, Assembly and Parts Employment, 1958–2002*

Note: Assembly includes SIC 3711 (Motor Vehicles and Car Bodies) and Parts includes SIC 3714 (Motor Vehicle Parts and Accessories).
Source: Employment, Hours, and Earnings from the *Current Employment Statistics Survey*, SIC basis (US Bureau of Labor Statistics).

[3] For example, according to company reports, Visteon has broad capabilities in chassis, climate control, electronics, glass and lighting, interior, exterior trim, and power trains. In 2000 the company operated 38 manufacturing plants in the United States and Canada; 23 in West Europe; 21 in Asia; nine in Mexico; six in East Europe; and four in South America. System and module engineering work was carried out in one facility in Japan, three in Germany, three in England, and four in the United States.

Supplier consolidation at the worldwide level has not progressed as far as in North America, but it has picked up speed in recent years as the formation of new global lead firms and groups, such as DaimlerChrysler in 1999 (a deal that was undone in 2007), Nissan-Renault in 1998, Hyundai-Kia in 1999, and GM's and Ford's purchases of several smaller companies, has led to some slow and partial consolidation and integration of formerly distinct supply bases. With the current economic crisis, some of these acquired companies may now be sold off, partially reversing this trend. For example, at the time of writing, GM is in the process of selling off its beleaguered SAAB division to a small low-volume Swedish sport's car manufacturer, Koenigsegg Automotive. On the other hand, some of the industry's largest mergers, such as the alliance between Renault and Nissan, appear to be quite stable.

As automakers set up final assembly plants in new locations and tried to leverage common platforms over multiple products, and in multiple markets, they pressured their existing suppliers to move abroad with them. Increasingly, the ability to produce in all major production regions has become a precondition to be considered for a project. However, what is emerging in the automotive industry is more complex than a seamless and unified global supply base, given the competing pressures of centralised sourcing (for cost-reduction and scale) and regional production (for just-in-time and local content). The need for full co-location of parts with final assembly varies by type of component, or even in stages of production for a single complex component or sub-system. Suppliers with a global presence can concentrate their volume production of specific components in one or two locations and ship them to plants close to their customers' final assembly plants where modules and sub-systems are built up and sent to nearby final assembly plants as needed.

What should be clear from this discussion is that the economic geography of the automotive industry cannot be reduced to a set of national industries or a simple network of clusters. Business relationships now span the globe at several levels of the value chain. Automakers and first-tier suppliers have certainly forged such relationships, and as the fewer, larger suppliers that have survived have come to serve a wider range of customers, these relationships have become very diverse. With consolidation and crisis, we must question the staying power of smaller, lower-tier, local suppliers, however well supported they are by local institutions and inter-firm networks, especially since many upstream materials suppliers, such as the automotive paint supplier PPG, are huge companies that have set up global operations as well.

3. EXPLAINING THE STRENGTH OF REGIONAL PRODUCTION IN THE AUTOMOTIVE INDUSTRY

Since the late 1980s, trade and foreign direct investment have accelerated dramatically in many industries. Specifically, a combination of real and potential market growth with a huge surplus of low-cost, adequately skilled labour in the largest countries in the developing world, such as China, India, and Brazil, has

attracted waves of investment, both to supply burgeoning local markets and for export back to developed economies. The latter has been enabled and encouraged by the liberalisation of trade and investment rules under an ascendant World Trade Organization (WTO). Yet regional production has remained very durable in the automotive industry. Because leaders in the automotive industry firms are few in number and very powerful, they have the strength to drive supplier co-location at the regional, national, and local levels for operational reasons, such as just-in-time production, design collaboration, and the support of globally produced vehicle platforms. But politics also motivates lead firms to locate production close to end markets, and this creates additional pressure for supplier co-location within regional-scale production systems.

While consumer tastes and purchasing power, driving conditions, and the nature of personal transportation can vary widely by country, local idiosyncrasies in markets and distribution systems are common in many industries, and it is possible to feed fragmented and variegated distribution systems from centralised production platforms, as long as product variations are relatively superficial. The continued strength of regional production in the automotive industry, then, is one of its most striking features (Lung et al., 2004).[4] The regional organisation of vehicle production stands in stark contrast to other important high-volume, consumer-oriented manufacturing industries, especially apparel and electronics, which have developed global-scale patterns of integration that concentrate production for world markets in a few locations.

Why is political pressure for local production felt so acutely in the automotive industry? The high cost and visibility of automotive products, especially passenger vehicles, among the general population can create risks of a political backlash if imported vehicles become too large a share of total vehicles sold. This situation is heightened when local lead firms are threatened by imports. The case of Japanese exports to the United States in instructive. In the 1960s and 1970s, Japanese (and to a lesser extent European) automakers began to gain substantial market share in the US market through exports. Motor vehicle production in Japan soared from a negligible 300000 units in 1960 to nearly eleven million units in 1982, growing on the strength of Japan's largely protected domestic market of about five million units plus exports (Dassbach, 1989). Excluding intra-European trade, Japan came to dominate world finished vehicle exports by a wide margin, with the bulk of exports going to the United States (Dicken, 2007).

The remarkable success of Japanese automakers' export strategy resulted in a gain in market share in the United States that came at the direct expense of the 'American Big 3', sparking a political backlash that resulted in the setting of 'voluntary' limits to market-share expansion via exports. A stark reality added fuel to the fire: American automakers had been, and continue to be, unable to penetrate Japan's domestic market in any meaningful way. In response to these so-

[4] Of the three major vehicle-producing regions, regional integration is the most pronounced in North America. In 2004, 75.1 percent of automotive industry trade was intra-regional there, in contrast to 71.2 percent in Western Europe, and 23 percent in Asia (Dicken, 2007, 305).

called voluntary export restraints (VERs), Japanese automakers embarked on a wave of plant construction in the United States during the 1980s, and by 1995 were locally manufacturing two-thirds of the passenger vehicles they sold in the United States (Sturgeon and Florida, 2004).[5]

As Japanese 'transplant' production in North America ramped up after 1986, Japanese exports began a long decline. By 2009, transplants in North America will have the capacity to assemble more than six million units, more than one-third of projected US demand in 2011, and will employ approximately 90000 workers, just under one-third of North American assembly employment in 2005 (Sturgeon et al., 2007). Because of the high cost, large scale, and long life of assembly plant investments, there has been a cyclical pattern of rising finished vehicle imports to the United States, as market share has shifted in favour of non-US-based firms, followed by new assembly plant investments that substitute for imports. In this way, plants in Japan are kept in operation as new market share is absorbed by new capacity in North America. This pattern can be expected to continue in the future if market share continues to shift away from the Big 3, but new plants will only be added if, and when, non-US-based firms are confident that market share gains in North America will be long standing.

This pattern reveals the sensitivity to high levels of imports, especially of finished vehicles, in places where local lead firms are present, as they are the United States and Europe. In our view, the willingness of governments to prop up or otherwise protect local automotive firms is comparable to industries such as agriculture, energy, steel, utilities, military equipment, and commercial aircraft. As a result, lead firms in these industries have adjusted their sourcing and production strategies to include a large measure of local and regional production that firms in other industries have not. This explains why Japanese, German, and Korean automakers in North America have not concentrated their production in Mexico, despite lower operating costs and a free trade agreement with the United States (Sturgeon et al., 2007).[6] Japanese automakers have also shifted European production to Eastern Europe later and less aggressively than American and European lead firms, and have even moved to China later than their European and American competitors have.[7]

Despite the rise of a more integrated global supply base, described earlier, the continued strength of regional structures in the automotive industry is still reflected in the relationship between supplier headquarters and regional sales. As recently as 1999, almost half of the 100 largest suppliers were based in North

[5] Around the same time, starting with Nissan in 1986 in the United Kingdom, Japanese firms constructed assembly plants in Europe to avoid import quotas in France and Italy and import tariffs in most other EU countries.

[6] Volkswagen is exceptional in that it has concentrated all of its North American production in Mexico, and Nissan is the sole Japanese automaker that has built up large-scale, export-oriented final assembly there.

[7] The large US trade deficit with China might have influenced Honda's decision to export the Honda Jazz to the European Union from China, while the almost identical Honda Fit for North America is shipped from Japan.

America, as this was the largest regional market. At the same time, regional sales were 70 percent of total sales for suppliers based in North America, and 65 percent for suppliers based in Europe and Japan.

However, Figure 16.3 illustrates that this situation changed in the following years, as global sourcing by lead firms increased extra-regional sales by Tier 1 suppliers. First, global sourcing has caused the list of top suppliers to become more regionally balanced. The number of top suppliers coming from each of the three regions, in the left panel, now reflects the worldwide production share of the lead firms of the respective regions. Second, by 2005 average sales in home regions declined from 68.6 percent to 61.6 percent for the 100 largest suppliers, which are shown broken down by region in the right panel. The decline has been particularly pronounced for North American based suppliers. Asian headquartered suppliers increased extra-regional sales modestly and European suppliers' extra-regional sales remained flat during the same period. Nevertheless, examples abound of suppliers from Germany and Japan following their largest customers offshore as extra-regional final assembly has grown.

4. THE LONG HISTORY OF GOVERNMENT INTERVENTION IN THE AUTOMOTIVE INDUSTRY

As we have argued, the automotive industry has long been deeply affected by protectionist measures and other forms of government intervention. Technical

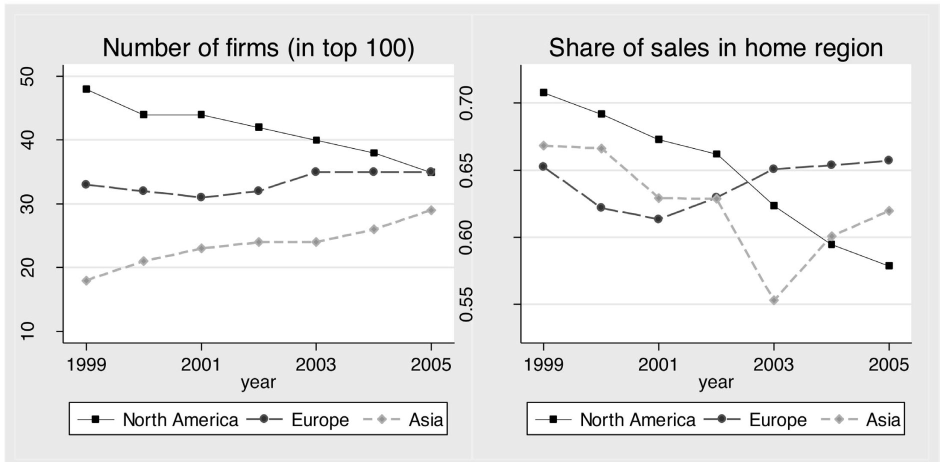

Figure 16.3: *Regional Organisation of the Automotive Supply Base*

Source: Automotive News top supplier list (various years).

necessity, political sensitivities, and market variation have kept final vehicle assembly, and by extension much of parts production, close to end markets. Powerful lead firms and industry associations, large-scale employment and relatively high rates of unionisation, and the iconic status of motor vehicles in the minds of consumers and policy-makers have increased the political clout of the automotive industry. So even where import tariffs and local content rules are not present, or are scheduled to decline under WTO rules, foreign assemblers have accepted VERs and set up local production to forestall political backlash. As a result, regional and national production structures remain surprisingly strong and coherent in comparison to other volume goods-producing industries where global sourcing of parts and materials is the norm, and worldwide demand for finished goods can be met from a handful of giant production clusters. Political pressures go a long way toward explaining patterns of direct investment in the automotive industry, and the regional value chains that surround these investments.

The clearest version of this is protection of local industry through tariffs, local content rules, and miscellaneous fees. However, more subtle non-tariff barriers also exist, such as regulatory requirements for emissions, or safety equipment that might exclude specific vehicle models, closed distribution networks, and VERs that automakers agree to under pressure. Since these policies have been in force for so long, they have become embedded in the structure of global value chains in the automotive industry. Corporate strategy considers these policies, and even anticipates a backlash if exports to a specific country increase beyond a 'reasonable' threshold.

In the United States, as we have seen, trade in finished vehicles is effectively capped by VERs and expansion of market share has been achieved through FDI for local production. This policy is not as nationalistic as it seems, from the point of view of corporate ownership. Vehicles produced within the borders of NAFTA and the European Union, by any company, are given a pass as long as they meet local content requirements. In other words, the classic protectionist scenario, where local industry is protected behind tariff walls, does not imagine the massive FDI and supply-base globalisation that we've seen in the auto industry. Even if such policies were to be abolished definitively, the high cost and long-lived character of the investments needed for automotive production make it likely that 'build where you sell' strategies will be long lived as well in the world's largest markets (for example, the United States, Western Europe, China, and India).

Protection, in the United States, mainly in the form of VERs, has worked to bolster local employment but not local firms. Lavish investment subsidies at the state level have added a pull factor. So VERs plus investment subsidies have created massive incentives for Japanese and now Korean producers to shift production to NAFTA, mainly to low-cost 'right-to-work' states in the US south, something the Big 3 have been unable to do while maintaining labour peace with the United Auto Workers (UAW) union. Costs are lower for foreign automakers. Operations in the United States do not carry the same legacies for health care and pensions that production in Japan does. Over the long run, VERs plus state-

level investment subsidies have created strong competitors in the US backyard, operating with lower costs. Employment has been maintained, while average wages have declined. This is not the whole story of the demise of the Big 3, obviously (for example, there have also been quality and product-mix issues), but only now have *nationalistic* subsidies and bailout, focused on domestic firms, become part of the picture.

5. THE AUTOMOTIVE INDUSTRY IN THE 'GREAT RECESSION'

The global financial crisis that began in the fall of 2008 severely deepened an ongoing global economic recession that had been underway since early in the year. At the same time, a combination of continued high demand (for example, from China) and investor speculation had driven commodity prices to unprecedented levels during the summer (light crude oil prices peaked at $147 per barrel in July 2008). We refer to the aftermath of these combined factors, which continue to unfold at the time of this writing, as the 'Great Recession'. The impact of the Great Recession on the automotive industry has been more severe than for any other industry except housing and finance. There are several reasons for this. First, as we have already discussed, the industry, especially the value chains led by the American Big 3 automakers, was already in a dire situation. As the recession deepened during the first half of 2008, the speculative bubble in petroleum markets created a spike in gasoline prices, driving buyers further away from the low-mileage trucks and sport utility vehicles that were the Big 3's comparative advantage. For companies already on life-support, the freezing of credit markets meant cancelled orders, unpaid supplier invoices, and 'temporarily' shuttered plants. Huge debt loads, high fixed-capital costs, high labour costs, and immense pension and health care commitments to retirees added to the immediacy of the damage. Rising commodity prices aside from oil also drove materials costs higher. Second, the high cost and growing longevity of motor vehicles prompted buyers to postpone purchases that they might have otherwise made. Consumers, especially in the world's largest national passenger vehicle market, the United States, found it difficult to obtain loans for purchase and, driven by fear of job loss, moved aggressively to increase their rate of saving. Vehicle sales plunged and as a result, beginning in the fall of 2008, pushing the industry into its most severe crisis ever. In the United States, politicians, pundits, industry analysts openly speculated about the demise of the domestic automotive industry.

In this environment, Congress, supported by a new Obama administration unwilling to preside over the liquidation of the United States largest manufacturing industry, offered several waves of bailouts, but only after a series of humiliating Congressional hearings where Big 3 CEOs made the case for government assistance and were aggressively cross-examined about management's culpability for the crisis. In the aftermath, General Motors' CEO resigned and the company was forced to file for Chapter 11 bankruptcy. Chrysler also filed for bankruptcy, and narrowly avoided a break-up through partial liquidation and

sale of its more lucrative assets to the Italian automaker Fiat, which is providing technology and management support in an effort to restructure the company to make it viable again. While it is widely believed that Ford has not yet asked for or received government assistance, the company did accept a $5.7 billion 're-tooling loan' from the Department of Energy to develop more fuel-efficient cars and trucks in June 2009. In Europe too, bailouts were provided.

The immediate motivation for government intervention in the auto sector was the unprecedented collapse in sales in almost all countries. In the United States, one of the most hard-hit countries, sales of light passenger vehicles in the first three months of 2009 were 38.4 percent below the level for the same period in the previous year, which itself was already 8 percent lower than in 2007. The reduction was somewhat smaller in Europe, 17 percent below the 2008 level, but that was largely due to the success of the 'scrappage' subsidies in Germany. Excluding Germany, European sales were 24.7 percent lower in the first three months of 2009 versus 2008.[8] Even in China, the world's fastest growing automotive market, 2008 passenger vehicle sales dropped to single-digit growth for the first time in 10 years. With sales reductions of this scale, any company operating in an industry with high fixed costs would struggle to remain profitable. The losses at Chrysler and GM were staggering, but even the most successful companies ran into trouble. Toyota, for example, recorded its first loss in the more than 70 years it has been manufacturing cars. In the first quarter of 2009, its losses ($7.7 billion) were even higher than GM's ($6 billion). Ford, even though it has so far avoided bankruptcy, recently 'celebrated' the fact that it was 'only' losing $1 billion per month!

There are a number of reasons for the decline in sales. Very strong vehicle sales in the previous decade, fuelled by massive discounts, created saturated markets.[9] By 2006, there were 1.2 vehicles registered in the United States for every driver's licence. As already mentioned, increased vehicle durability made it more feasible than ever for households to postpone the replacement of their current vehicle when recession hit. The industry has always been highly cyclical, as most durable goods industries are, but increased durability and the severity of the current recession exaggerated this tendency. Furthermore, high fuel prices raised the cost of operating a vehicle, enticing credit- and cash-constrained buyers to keep existing vehicles when loans on their vehicles were paid off. The increase in vehicle registration fees, environmentally motivated in Europe and driven by the need for state governments to balance their budgets in the United States, added further to vehicle operating costs. Finally, the notion that some transition to a new drive-train technology – hybrid, electric, or fuel cell – was imminent, made consumers uncertain and unwilling to buy an expensive asset that might depreciate

[8] Sales statistics are taken from the online databank of Automotive News.

[9] This is especially the case for the United States where between 2002 and 2006 84 million vehicles were sold. This was unexpected as there was a mild recession and over the preceding five years, the boom times, there had already been 84 million vehicles sold, with many annual records and an absolute sales record of 17.8 million vehicles in 2000.

rapidly.[10] Governments contributed to this uncertainty with discretionary and unpredictable subsidies for fuel-efficient vehicle purchases and (or) retiring of old, less-efficient vehicles.

5.1 Motivations for government intervention in the automotive industry during the Great Recession

During the Great Recession nearly all sectors have experienced reduced sales and firms teetering on the edge of, or falling into bankruptcy, but only in the banking sector did the government intervene at a larger scale than it did in the automotive industry. The systemic importance of the banking sector explains the motivations for interventions there, but why the automotive industry? We see six reasons:

1) *is believed to be feasible and manageable*: As we have discussed earlier, the automotive industry is extremely concentrated at the top. Lead firms are very large and few in number and the value chain is structured in a clear, hierarchical way. As a result, government officials believe they can effectively assist the industry by propping up lead firms, and in turn continue to generate business for thousands of the upstream suppliers. In the United States, this industry structure was even used administratively: five billion dollars worth of credit targeted for suppliers was doled out by lead firms, a decision that will undoubtedly work to increase the power asymmetry discussed earlier.
2) *Political sensitivity is acute*: Large bankruptcies can create political reactions in any industry or country, but large, regionally concentrated employment in the automotive sector and strong labour unions made it all the more difficult for politicians to let large firms in this sector fail, especially at a time when the aggregate labour market was very weak.
3) *Multiplier effects boost the rationale for automotive industry bailouts*: The notion of multiplier effects was frequently evoked as a justification for bailing out automakers. Research by McAlinden and Swiecki, originally published in 2003, estimated that each assembly plant job generated 7.6 jobs; 2.9 jobs at suppliers and another 4.7 in service industries such as distribution and after-sales service. In 2006 an update of the original study boosted this estimate to 10 spill-over jobs per assembly plant job. While it is misleading to present such multiplier effects as indirect job creation, bailouts can minimise the increase in cyclical unemployment over the short term. [11]

[10] When fuel prices spiked in the summer of 2007, the reduction in resale value for low-mileage vehicles was immediate.

[11] To the extent that governments are concerned with slowing the pace of layoffs during a recession, making sure automakers keep operating is indeed a sensible strategy, especially when multiplier effects are invoked. However, if we take a long-term view that includes stable unemployment rates, there is no evidence that governments are able to boost aggregate employment by propping up specific firms in specific industries. Any job that is preserved in a country's automotive industry, directly or indirectly, means one less job filled somewhere else in the economy. However, job quality may be degraded in this process of job churn, and with massive deindustrialisation regional unemployment can remain high for long periods, even as aggregate unemployment stabilises.

4) *Stimulating vehicle demand is seen as an effective way to stimulate aggregate demand*: Customers can alter the timing of vehicle purchases more easily than most other purchases. Purchasing a new vehicle is often a discretionary decision, usually made when the household still has a working existing vehicle. Repair of existing vehicle or purchasing a used vehicle are viable options. While this causes sales declines to be larger at the start of recessions (triggering calls for intervention), it also makes demand-stimulus interventions quite effective, because consumers can also move purchases forward. Hence, a major component of fiscal stimulus in many countries has focused on stimulating demand for passenger vehicles.
5) *Stimulating vehicle demand has environmental side-benefits*: The high fuel prices of the summer of 2008, along with rising concern over carbon emissions, awakened politicians, once again, to the importance of reducing the consumption of fossil fuels. Policy measures have included CO_2 taxes, higher fuel efficiency standards, and R&D for technology development. Because almost all vehicles in development have better mileage than the models they replace, stimulating vehicle demand has the side effect of increasing the average fuel efficiency of the fleet.
6) *Bailing out automakers helps to solve credit problems*: In most countries, the bulk of vehicle sales are financed (90 percent in the United States). Tightening credit conditions for customers made it much harder to obtain vehicle financing than in normal circumstances. The operations of GM and Chrysler are deeply intertwined with their finance companies, and often depend on them for profits. The difficulty for these firms to obtain credit themselves made it impossible for them to provide consumer financing, and hampered their usual role in financing working capital (vehicle inventories) in dealership networks.

Because the policy objectives, justifications, and motivations for interventions and bailouts have been so numerous, and the actions taken so swift and complex, it is hard to evaluate them. No single criterion – the rescue of an individual firm, the slowing of unemployment, the repair of credit markets, the reduction of carbon emissions, or stimulation of aggregate demand – can be used as a measure of success. Clearly, policies that seek to achieve multiple objectives are laudable, but the debate has been muddied because different objectives and outcomes have been emphasised by different policymakers and with different constituencies. In the end, without clear metrics and known counterfactuals, we are left to with the hope that interventions, in the aggregate, have had positive effects. Better analysis may be possible *ex post*.

5.2 The ladder of government intervention

Virtually every government with a sizeable automotive industry has intervened in some way or another during the Great Recession. In this section, we organise the discussion according to a 'ladder of intervention', from less drastic and controversial to more so. As problems with individual companies worsened, gov-

ernments have found themselves climbing this ladder quite rapidly. As we discuss each intervention, we indicate where different countries have progressed.

Credit warranties: This is the least controversial form of intervention. Most countries have initiated schemes to guarantee or extend credit, and these are typically not limited to the automotive industry. They have been used in various forms such as buying up and backing up various types of loans. A popular approach to support the automotive industry is to earmark loans for R&D or vehicle development to boost fuel efficiency (as in Sweden, France, and the United States), although firms can of course move funds around internally. In many instances, the loans are secured by company land or buildings (as was the case in Sweden), or have taken the form of a sale and lease back of the physical assets (this was Belgium's proposal to GM).

1) *Recapitalise financing units:* Recapitalization is similar to credit warranties and to interventions in the banking sector, with an important difference that there is often very little or no equity participation by governments. The fall in both new and used vehicle demand forced large losses at financing units active in the leasing market. Compared with banks or other financial institutions, there are few retained earnings in automaker's credit arms to strengthen the company's equity position, because earnings are passed on to keep manufacturing units afloat. There is also little convertible debt because investors did not view the option of holding automakers' equity as attractive. In the United States, GMAC has been turned into a bank holding company, much like the troubled investment banks, recapitalised by the government and placed under close regulatory oversight of the Federal Reserve.
2) *Purchase subsidies for consumers:* Providing purchase subsidies directly to the consumer benefits automakers and suppliers, stimulates the broader economy, and is easily monitored. Because of this, they were widespread. In most countries, rules were put in place to yield environmental benefits as well. Since most programs have been quite generous, they have been extremely popular with consumers. The United States provided a total of $3 billion at $4,500 per vehicle as long as a new vehicle was purchased, the old one was scrapped, and the fuel efficiency improved by 5 miles per gallon or more. Germany launched the largest program, allocating €4.5 billion, but replaced vehicles had to be at least 10 years old to qualify. In Belgium and France the subsidy increased with the fuel efficiency of the new vehicle and the old vehicles did not have to be scrapped. In China, the government instructed banks to provide easier credit and dropped the sales tax on vehicles with engine sizes of less than 1.6 litres. The macroeconomic effect of these programs has been large, particularly in Germany. Whether they will prove a drag on sales after they expire because they have moved purchases forward remains to be seen.
3) *Provision of working capital and interfering with management:* The direct injection of working capital to specific companies is unlikely to come without policymakers gaining some influence over decision-making, although gov-

ernments have been at pains to stress that they were not interfering with the day-to-day operations of firms and that they plan to sell their stakes at the first opportunity. Germany is arguably in this stage now. Just before General Motors filed for Chapter 11 restructuring in the United States, its European assets (Opel) were put into a *Treuhand*[12] and the German government provided €1.5 billion of working capital. The government is now actively involved in negotiating with possible takeover candidates for the assets. One of its principal objectives is to make the unit viable again while gaining some influence over which plants are to be closed. Other European governments with Opel plants are not entirely happy with this course of action. While bridge financing from Germany is keeping Opel in operation for now, the governments of Belgium, the United Kingdom, Poland and Spain, have lost almost all influence over decisions about where capacity will be reduced.

4) *Takeover liabilities:* This is similar the provision of working capital without the expectation that the loans will ever be repaid. In this case, governments become even more extensively involved in the management of the firm. For example, before agreeing to participate in the US-led bailout of Chrysler and GM, Canada demanded additional wage concessions from the unions and a complete plan of future plant closures and restructurings, with remaining employment and timetables for staff reductions. A large part of its contribution went to fill a large deficit in GM's Ontario pension fund and to resolve a dispute with Chrysler over back taxes. While there is an explicit understanding by the government that a large part of its contribution is technically a loan, we believe that there is no real expectation of repayment.

5) *Quasi-nationalisation:* Undeniably, the US government went furthest in its interventions. It started with loans to develop clean vehicle technologies ($20 billion for the industry) and recapitalising of financing arms of GM (for example, GMAC received $5 billion in December 2008, an additional $7.5 billion in May 2009, and has asked for additional injection of between 2.8 billion and 5.6 billion dollars in October, 2009).[13] As already mentioned, another program of $5 billion to provide the supply sector with credit was run through automakers. It is difficult to identify and quantify all of the various interventions, but the total support for GM, including debtor-in-possession financing stands at around $62 billion. The total for Chrysler stands at about $12 billion. Both Chrysler and GM have emerged from their Chapter 11 procedures with the US government and the UAW labour union as principal shareholders. Large segments of GM are being liquidated, and Delphi, the huge

[12] The original *Treuhand* was established in 1990 to oversee the restructuring and privatisation of state assets after German unification. The current structure is only partially state owned, but is similarly overseeing Opel's assets while looking for a suitable buyer.

[13] The restructuring of the financing arms was complicated because the largest shareholder of GMAC was Cerberus, which also owned Chrysler. Chrysler Financing was split from the manufacturing company in 2007 when Cerberus took control. It was in much better shape, as it had not branched out into a variety of ancillary banking activities, as GMAC had.

parts company spun off from GM in 1999, is being split in two, with one half being re-absorbed into GM and the other half liquidated. In addition, the Canadian government contributed US$3.2 billion to Chrysler and US$9.5 billion to GM. The Canadian and Ontario governments became minority shareholders of the 'new GM'. The Italian carmaker Fiat has joined the US government and the UAW as a Chrysler shareholder. They did not invest cash, but will license technology to Chrysler and help in its restructuring. Because of their huge investments and controlling stake, the US government has taken some managerial control over GM and Chrysler. Even before formally becoming a shareholder, the government appointed a new GM CEO, for example. It has demanded wage cuts, restructuring of the product portfolio, and plant closures. President Obama has further signalled that he will use the government's clout to make sure these companies make more fuel-efficient vehicles. The stated objective is to sell its ownership shares as soon as possible, but before this can happen it has to be clear that the companies are financially stable.

In spite of the obvious recent and dramatic effects of the Great Recession on the automotive industry, it is important to take a long-term perspective. Recent events will serve to hasten long-term trends, most notably the shift of automotive production to developing countries, where sales growth is strongest, consolidation in the supply base, and the internationalization of automakers from developing countries (e.g., Geely, a Chinese state-owned automaker, is making a bid to take over Ford's Swedish car unit, Volvo). In Table 16.1, we list all countries that pro-

Table 16.1: *Passenger Vehicle Production Levels and Growth in Countries Producing One Million or More Units in 2008 (in thousands)**

	2002	2007	Annual growth 2002–07 (%)	2008	Annual growth 2007–08 (%)
Spain	2,855	2,891	0.25	1,940	–32.90
Canada	2,629	2,602	–0.21	2,068	–20.52
United Kingdom	1,821	1,770	–0.57	1,450	–18.08
United States	12,280	10,611	–2.88	8,746	–17.58
Italy	1,427	1,284	–2.09	1,085	–15.47
Germany	5,145	6,200	3.80	5,500	–11.29
South Korea	3,148	4,085	5.35	3,830	–6.24
Mexico	1,805	2,254	4.54	2,154	–4.44
India	892	2,046	18.06	2,022	–1.20
Japan	10,258	11,596	2.48	11,564	–0.28
Turkey	340	1,097	26.40	1,147	4.57
China	3,251	8,890	22.29	9,340	5.06
Russia	1,220	1,654	6.28	1,776	7.40
Brazil	1,793	2,960	10.55	3,210	8.45
Thailand	540	1,178	16.88	1,400	18.85

Sources: Data for 2002 and 2007 and for North American countries and Japan are taken from Automotive News. Other information comes from various Internet sources, mostly from newspaper reports and national industry associations.
* Two countries are missing: France (3.01 million vehicles in 2007) and Iran (1.18 million in 2007); 2008 production volumes were not available for these countries.

duced more than 1 million vehicles in 2007 (except France and Iran). They are ranked by annual production growth rates over the 2007–08 period, which is negative for most countries. It is clear from this table that the crisis-induced production contraction has been most pronounced in countries that have experienced the slowest rate of production increase over the preceding five years. The table also shows China, where the rebound in sales has been particularly strong, surpassing the United States for the first time in 2008 as the number two auto producing country in the world. Looking at these trends and considering the pending plant closures in North America and Europe, we have to conclude that at least part of the current production decline in mature markets is likely to be permanent and that China will soon occupy the top spot and keep it for the foreseeable future.

6. POLICY DISCUSSION

What can have been learned from the recent crisis in the automotive sector and the government responses? Although the process of restructuring is still underway, we can make several observations, as follows.

- Economic nationalism cannot be ignored in this industry. To a remarkable extent, countries are willing to put money on the line to support national champions, even if this angers their trading partners or political allies. The strength German government's interest in supporting Opel may be due, not only its position as a major employer, but also to its roots as a German company prior to its acquisition by GM in 1929. These political sensitivities strengthen the regional pattern of the GVC organisation of the industry, and are also likely to play a role once finished vehicle exports from developing countries, such as China or India, become viable, or when parts imports in Western economies pick up after the crisis. For example, if history is any guide, companies such as Tata (India) and Geely will have to establish or purchase substantial final assembly capacity in the (economic) heart of North America and Western Europe, in order to sell large quantities of vehicles in these regions, just as Japanese and Korean firms have done in North America and GM and Volkswagen have done in China. At the same time, locally owned firms are likely to continue to shift production to the low cost peripheries of East and Central Europe and Mexico to reduce operating costs. It is clear that the tendency for vehicles to be built where they are sold, and manufactured in the context of regional production systems will not quickly fade away; it has only been reinforced by nationalistic government responses to the crisis of the Great Recession.
- It has proven impossible to coordinate capacity reductions internationally. As the hand of governments has become stronger, competition has shifted from inter-company to inter-country. For example, Canada paid an extraordinary amount per employee to keep some of its auto industry alive because it feared that contracting firms would be forced by the US government to focus their capacity reductions outside the country. Bridging finance and loan warranties in Europe have come with explicit request to concentrate layoffs abroad, violat-

ing the spirit of the state aid limitation guidelines set by the European Union. The same "beggar-thy-neighbour" dynamic occurs within countries when local jurisdictions compete to attract new investments.

- Chinese interests in purchasing struggling carmakers, BAIC (China) for Opel and Geely for Volvo, further illustrate the shift to the rising importance of developing countries (Thun, 2006). An important motivation for these firms acquisition efforts is to acquire advanced engineering and design expertise, which they have thus for outsourced to European-based firms (Whittaker et al, forthcoming). Currently, the balance of power in their domestic industries is tilted towards the local operations of global Tier 1 suppliers, which they share with Western joint ventures.
- The bid of the Canadian global supplier Magna for the automaker Opel highlights, on the one hand, the increasing importance of suppliers and, on the other hand, the relative, regional, operational independence of the European arm of GM from its other operations.
- From a GVC perspective, the incessant attention paid to automakers, the lead firms in the supply chain, have further weakened the relative position of suppliers. Even though Delphi employed approximately the same number of workers as its former parent, and filed for Chapter 11 in 2005, politicians only paid attention when GM inched towards bankruptcy in 2008. The decision by the Obama Administration to run the supplier support program through lead firms can only tie suppliers more tightly to old commercial relationships with firms that are losing market share.
- Governments' responses to the crisis have lacked clear objectives. There is no reason to believe that the shift of market share from one firm to another, and the ensuing troubles at the shrinking firms, will have a dramatic effect on total employment in the industry. The reality is that in mature economies, annual productivity growth outpaces increases in aggregate sales, which leads to falling employment in specific industries – something most manufacturing industries have been experiencing for several decades. If policymakers are alarmed by this, they should promote exports and help automotive workers find employment in other industries, rather than supportting specific firms.
- As work shifts to the supply base, value added (VA) at the assembly stage falls, leading to a greater protectionist effect even when import tariffs on finished vehicles are unchanged. This is particularly important in the automotive industry where lead firms have disproportionate power in the chain. Lead firms can force their domestic supply base – which invariably faces lower levels of protection than they do – compete vigorously with foreign firms, effectively enforcing world market prices for inputs manufactured at home.[14] All benefits of protectionism of the final product then accrue to lead firms. Effectively, lead firms are able to transfer the import tariff on the final good entirely onto components, which they purchase at world prices, and which make up an increasing share of the final cost of a vehicle.

[14] For evidence on component price convergence, see Thun, 2006.

Can recent government interventions be considered protectionist? On the one hand, government bailouts can be considered protectionist because they discriminate against foreign producers by assisting domestic and quasi-domestic companies only. A policy such as the extremely popular 'cash for clunkers' program, which subsidises the purchase of new high-mileage vehicles, does not discriminate based on the nationality of the automaker. As long as certain criteria are met, the policy subsidises and vehicle, whether it is domestically produced or imported. However, such policies can favour specific firms in subtle ways. Ford's popular Focus model became a strong seller with this program, but so did the already popular Toyota Prius hybrid, which is produced in Tsutsumi, Japan. Imports of high-mileage cars from South Korea to North America actually increased during the fourth quarter of 2008 and first quarter of 2009 (Wilson, 2009). In China, the government incentives for vehicles with engine sizes below 1.6 litres boosted sales at domestic firms, such as Chery and Geely, which offer smaller cars at the low end of the market (Reuters, 2009). On the other hand, this spike in small car sales may also be caused by the general economic slowdown. It may be part of a broader trend toward smaller cars, as traffic congestion worsens in large cities and the Chinese automotive market matures to include more owner-driven cars (many cars in China are chauffer-driven) and sales to individuals with highly constrained parking opportunities.

However, if a central motivation of protectionist legislation is to retain domestic jobs, as opposed to companies, the strong regional structure of GVCs in the automotive industry complicates the picture. If the American Big 3 were to fail completely (unlikely since the worst case scenario would most likely lead to a break up and sale of large companies rather than outright liquidation), it is very likely that the vast majority of vehicles in the United States would continue to be produced locally, by 'foreign' transplant factories owned by Asian and European automakers. American suppliers would certainly be hurt, but the largest have already diversified their customer lists to include all of the world's major automakers, and it is conceivable that smaller, domestically focused suppliers could find work with transplants, since market share would quickly swing in their direction, and orders would increase.

So now, when the US and EU policy makers provide bailouts to save 'the car industry' they really are moving to save (in the US case) the Big 3, their suppliers, and UAW jobs, not aggregate US auto employment, which, barring huge increases in finished vehicle trade, will certainly rebound to some degree when sales inevitably rebound and stabilise. There is of course some logic to this; the GVC perspective highlights the possibility of a global division of labour, where vehicle and technology development (and R&D and engineering jobs) stay largely at home, in places such as Japan, South Korea, China, and Italy. But this is not a bailout argument that has been made by policymakers.

In the end, policymakers need to be clear about the goals of their policies towards the automotive industry. Are policies meant to protect domestic jobs, domestic firms, achieve some other policy goal such as lower carbon emissions, or

some combination? How can successful policies be measured? Unfortunately, such questions are impossible to answer at this time. What is clear is that the growing importance of automotive production in developing countries is likely to accelerate as excess capacity in developed countries that has long been kept afloat is finally closed.

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17

Agriculture: The Dog that Did not Bark?

TIM JOSLING AND STEFAN TANGERMANN

1. INTRODUCTION

In a discussion of signs of the resurgence of protectionism in response to global recession it would be unusual not to feature agriculture. After all, that sector has for the post-war period been the poster-child for government policies that distort markets in favour of domestic producers. Agricultural protectionism reflects the unusual political sensitivity of farming and food production: coupled with uncertain world market conditions, the case for stimulating high-cost domestic output has been irresistible for countries that can afford such luxuries. World agriculture has just gone through another phase of major uncertainty on global commodity markets. Prices of cereals and other agricultural products rose to extreme levels in 2007 and the first half of 2008, triggering what has been described as another global food crisis. But commodity prices, including agricultural products, declined sharply in the second half of 2008, not least as a result of the economic and financial crisis. It would appear only 'natural' to find that governments around the globe have responded by shielding their domestic farmers from these erratic market forces. After all, when all manner of policy action is being designed to provide stimulus to ailing economies, politically powerful farm lobbies should be in a strong position to pressure governments into providing additional protection to farmers in these difficult times.

However, based on the evidence available so far, it appears that the response to the current economic crisis has not (yet?) included any major policy shifts towards agricultural protectionism. In an historical context this fact is remarkable. This chapter takes a look at the relatively limited policy action taken in agriculture, and attempts to explain why on this occasion 'the dog did not bark'.

2. THE EVIDENCE

Government trade-related action in the food and agricultural sector in response to the financial and economic crisis can take different forms, depending on the principal motivation behind the measure and on its implementation. Four major categories of policy action can be distinguished, with differing effects on trade:

- New border measures in favour of domestic producers in the food and agriculture sector.
- Quasi-automatic application of counter-cyclical trade measures in favour of producers that are authorised buy pre-existing programmes.
- New border measures in favour of domestic consumers (or other users) of food and agricultural products.
- Financial stimulus programmes targeting agriculture and food production that impact on tradeable goods.

These four categories of government action can be identified in the various lists of trade-related measures taken by governments that have become available in the last few months.[1] The table below (and the detail included in Appendix TableA17.1) is based mainly on the list appended to the report of the WTO's Director General to the Trade Policy Review Body (WTO 2009).[2] A second source of information used is the World Bank, which maintains an unpublished list of trade-related measures (World Bank, 2009a) and has issued a Fact Sheet on measures taken by the G20 countries (World Bank, 2009b). The World Bank lists report a number of cases in which governments have made proposals or pledges, without providing information on whether these measures have actually been implemented. These cases are not included in the list below, so there may be some under-counting of government actions.

The table below classifies 43 trade-related actions plausibly associated with economic crisis management. The most frequent new 'border measures' come in the form of tariff increases: nine countries are reported to have used trade measures directly to assist producers. Ecuador, Turkey, and the Russian Federation each imposed a tariff increase on a wide range of goods, including foodstuffs. Other countries have been more specific: China removed interim tariff reductions on soybean products and India imposed a duty on soybean oil; South Korea imposed a tariff on flour; Belarus imposed higher duties on Russian goods, although presumably not entirely as a result of the economic environment.

In four cases, new or more stringent SPS measures have also been reported, including a ban on Irish pork by China, and on US pork (from certain facilities) by Russia. Indonesia introduced a new import-inspection regime that limited entry points. It is obviously difficult to determine whether these are measures responding to the economic recession or whether they would have been introduced in any case. But the economic plight of domestic producers can sometimes tip the balance when Sanitary and Phytosanitary (SPS) measures are being considered.

[1] We omit the programs that benefit farmers along with other segments of the population. Stimulus programs generally available, as well as programs to facilitate trade and improve the availability of export credit may have significant advantages for agriculture along with other export sectors, but they are not discussed here.

[2] In the WTO list, a distinction is made between 'verified information' and 'non-verified information'. That distinction is not reported here.

Table17.1: *Incidence of Government Actions in the Area of Agriculture and Food*

Category of Measure	Number of Countries	Number of Actions	Examples (number of cases)
New Border Measures Benefiting Producers	15	19	Increase in Import taxes (9) Introduction of SPS measures (2) AD and CVD measures (3) Elimination of export taxes (4) Increase in export subsidies (2)
Counter-cyclical Measures under existing legislation	2	3	Re-introduction of import duties (1) Re-introduction of export subsidies (2)
New Border Measures Benefiting Consumers	7	9	Reduction in Import Taxes (5) Removal of SPS Measures (2) Introduction of export taxes (2)
Financial Stimulus to the Farm Sector	13	14	Funds for rural development (1) Increased price support (3) Input subsidies (3) Income support (3) Improved rural credit (4)

Source: Appendix Table A7.1

The same doubts hold regarding the three anti-dumping or countervailing duties reported in this category, as they might also have been imposed even in the absence of the crisis. Egypt imposed anti-dumping duties on sugar. The European Union imposed anti-dumping duties on fruits from China, and both anti-dumping and countervailing duties on biodiesel imports from the United States, though the latter case has been simmering for some time.

There are four cases in which export taxes have been reduced or eliminated in part as a response to the economic crisis. Argentina eliminated several export taxes, as did India on Basmati rice exports, Indonesia on palm oil, and Vietnam also on rice exports. In each case these actions removed taxes imposed a few months earlier to keep domestic prices down. Export assistance has been given by India for textiles and leather goods, and by Vietnam for a range of products.

Only three instances of a WTO member employing a quasi-automatic counter-cyclical trade measure, already authorised in pre-existing legislation, are recorded in the list. In two cases, the European Union re-introduced trade measures that had been suspended at the time of high prices. Cereal duties came back as world prices declined, and export subsidies for dairy products also resurfaced – to the disappointment of overseas competitors. But it is difficult to see how the European Union could have avoided these moves without in effect repudiating its own agricultural policy. In a similar case, the United States has re-introduced dairy export subsidies under the *Dairy Export Incentive Program* (DEIP) in response to the fall in world dairy prices.

The short list of counter-cyclical measures by countries, applied at the border or in the form of domestic subsidies, undoubtedly understates the importance of this category of action. Many countries' agricultural policy regimes include meas-

ures that automatically provide additional support or protection to domestic farmers when market prices decline.[3] The widespread use of such counter-cyclical measures in agricultural policy packages of the OECD countries is evident in the year-to-year fluctuations of the Producer Support Estimate (PSE) as reported by the OECD (for example OECD, 2008) which moves inversely with the level of international market prices of agricultural products. Falling international prices of agricultural commodities after the 2008 food crisis have resulted in higher levels of domestic support and (or) border protection in these countries. Because of the automatic nature of these regimes, the respective policy action often does not require any explicit government decision. It is probably for that reason that most of the counter-cyclical policy action is not reported in the media. Yet the economic implications of the respective (implicit) policy action can be significant. For example, the World Bank reports that "US overall trade distorting subsidies [in agriculture] of about $8.1 billion in 2008 are likely to rise to $9.9 billion in 2009 if current price projections materialise" (Gamberoni and Newfarmer, 2009).

Besides measures obviously providing protection and support to domestic farmers, there has also been some action pointing in the opposite direction, that is exerting downward pressure on domestic prices of agricultural products. A number of such cases of new border actions in favour of domestic consumers (or other users) of food and agricultural products have been evident in the past few months. Nine cases of this nature are included in Table 17.1. Import tariff reductions have been reported in five instances, though several other countries had lowered tariffs earlier as a response to high commodity prices. Of the new measures noted in recent months, Ecuador reduced tariffs on a range of imported raw materials. India abolished tariffs on soybean oil and sugar, and the Philippines reduced tariffs on wheat, soybeans, and distillers' dried grains (an animal feed). Tunisia also is reported to have made widespread tariff reductions. Resolutions of SPS problems have also occurred in a couple of instances, as Japan lifted a ban on Chilean pork and South Korea agreed to resume imports of US beef. India introduced export taxes on leather goods and Russia, also, has increased export taxes for leather products. Tariff reductions operate in the direction of more liberal trade in agriculture, and so do not constitute a move toward protectionism. However, the increase in export taxes is not strictly a trade-friendly action and may encourage protection in importing countries. And even when tariffs are reduced, these measures can be designed to benefit domestic producers in sectors that use agricultural products as inputs.

'Stimulus programmes' have not commonly targeted agriculture, although farmers have of course benefited from more general schemes such as tax rebates. This may in itself reflect the reduced importance of agriculture in the economy

[3] Deficiency payments, a subsidy paid that bridges the gap between a pre-determined domestic target price and the actual market price, are an example of such counter-cyclical regimes operating in the domestic market. Variable import tariffs are banned under the *Agreement on Agriculture* although some related measures still exist. Export subsidies can be varied within the limits specified in the Member's schedule.

of those countries that have the ability to make these transfers. In the 1930s it was believed that recessions were 'farm led and farm fed' implying that the health of the rural economy was an important factor in the wider economic picture. This was an important motive behind the introduction of farm price-support policies at that time. But the absence of any major schemes to prop up rural incomes as a way of rescuing the economy suggests that this avenue is less attractive nowadays.

However there have been some 14 examples of stimulus payments aimed at rural incomes. This category includes various forms of domestic subsidies. The stimulus package introduced by China contains a significant increase in spending on agricultural programs, although reportedly still within the constraints of the WTO schedule for that country. The European Union introduced, as a part of a stimulus package, an increase in funds aimed at rural development, and several member states of the European Union provided modest additional funds of their own. In a move to support domestic farmers, Germany reduced the tax on diesel used in agriculture. India raised cotton price supports, and Sri Lanka added a fertiliser subsidy, though it is possible that some of these payments could have been made even without a widespread economic crisis – and indeed might have been more generous if there had not been other competing uses for government funds. One constructive aspect of the stimulus programs has been the freeing up of the credit markets: several countries have targeted agricultural credit, including Brazil, Poland, Russia, and Spain as a way of encouraging economic recovery.

3. WHY DID THE DOG NOT BARK?

The picture that emerges from the examination of government actions is one of several small changes in trade policy that are often limited to individual products. Most of these have been in developing countries and have probably not had a major impact on trade. The industrial countries have not reacted in a protectionist way: apart from the quasi-automatic reintroduction of cereal tariffs and dairy export subsidies by the European Union and the United States (a reaction to weakening world market conditions) there has been, to date, no widespread surge in new agricultural protection at or inside the border. The combination of the commodity boom that preceded (though did not cause) the economic bust and the restraints under the WTO have allowed governments to resist such temptations.[4]

Three possible explanations come to mind. First, government policies towards agriculture may have changed fundamentally: the dog itself may have modified its behaviour. If this is the case, the reasons certainly demand an explanation and the emergence of agriculture from the policy dog-house should be welcomed. A second explanation may be that there has been no reason to intervene in agri-

[4] The fact that the WTO talks are still ongoing may also have made countries hesitant in using trade measures in agriculture that would have weakened their position at the negotiating table.

cultural markets on this occasion: the dog may have had nothing to bark about. This argument is plausible, in that agricultural prices had been very high in 2007-08 and governments may have decided that no financial intervention in the sector was warranted. But this is to argue that the lack of response was due to a temporary event. Vigilance would still be warranted if prices weaken further and costs stay high. The third explanation is that the interventions have been below the radar: the dog was barking but the sound was drowned out by other louder noises at the time. If this were the case, then there could be some useful policy lessons even if the government actions never made the headlines.

The argument that agricultural policy has undergone a fundamental change is attractive. Farm policy in industrial countries began to change in the mid 1980s, with a noticeable shift away from the support of commodity prices toward direct payments to farmers that interfered somewhat less with the price signals from the market. This in turn created a new 'political economy' of the rationale for and distribution of the direct payments, and new actors emerged on the scene to press the case for environmental and other objectives to be included as conditions for receiving the funds. Food safety concerns brought other actors onto the stage and further diluted the power of commodity interests. An awakened interest in food quality offered farmers an alternative way to earn a living: produce for the market and not for the government stockpile.

The UR *Agreement on Agriculture* introduced disciplines on agricultural policies and border measures that supported such policies. The rules have been generally effective, eliminating most non-tariff import measures such as variable levies and quotas (although at the cost of introducing tariff rate quotas, which are proving difficult to remove) and disciplining both domestic and export subsidies. The shift toward direct payments that are more or less decoupled from production has been encouraged by the subsidy disciplines, as domestic support that is not connected to current price and output has not been subject to reduction under the *Agreement on Agriculture*. The changing policy paradigm, promoted in international bodies such as the World Trade Organization and the OECD and supported by academic research and policy debates, has also contributed to a tendency to replace policies that strongly distort markets and trade. Export subsidies have been reduced on schedule and now are limited to a few products. The slow-moving Doha Round is designed, in the context of agriculture, to tighten these disciplines with significant cuts in tariffs, elimination of export subsidies, and drastic reductions in the ceilings for trade-distorting domestic support.

The political influence of agriculture has also declined in the past couple of decades. Though the US Farm Bill in 2008 was seen as a victory for those that wanted to retain the core programs for corn, wheat, soybeans, rice, and cotton, the process exposed a polarisation of views that may suggest that change could come in the next few years. The European Union has a core group of member states that support the Common Agricultural Policy (CAP), but the Commission has skilfully continued the process of reform by finding winning coalitions on key topics. But whether this weakening of the political support for 'traditional' farm

programs presents an explanation for the lack of a protectionist reaction to the economic slowdown is not so clear. The influence of producer interests on farm programs is still the dominant factor in policy determination.

In the absence of fully convincing evidence that the underlying politics of agricultural support has changed fundamentally, the more plausible argument is that the farm sector in the industrial countries has not been badly impacted by the economic crisis. The commodity price boom that preceded the financial collapse had indeed provided farmers with a cushion. Land prices did not collapse with other forms of real estate. And though some of the windfall profits from the commodity price spike were curbed by several governments to 'protect' consumers by restricting exports, as prices eased farmers benefited from the relaxation of these restrictions. Moreover, prices are still above historic levels and so political pressure for farm rescue packages is muted.

A major economic reason behind the lack of need for stimulus packages to be aimed at farmers is the relative resilience of agriculture in times of economic recession. As incomes decline, the demand for food shrinks only marginally. The income elasticity of demand for basic food and other agricultural products tends to be low, and so the farm sector may be much less affected by an economic slowdown than other parts of the economy. Several other parts of the rural economy, however, may be more affected – such as agro-tourism. So governments may emphasise rural development as opposed to farm incomes in their strategy to provide protection against recession.

What of the argument that there has indeed been considerable government activity involving agriculture, although the scale of that activity has been dwarfed by measures taken in other sectors? There may well be some merit in this explanation. If the evidence provided above, based on the lists of policy action that have become available so far, is reasonably comprehensive then it appears to be the case that there has been a variety of reactions to the economic crisis that favour agriculture. Though the scope and intensity of protectionist measures taken in agriculture in recent months has indeed been relatively limited, it has not been absent.

4. POLICY LESSONS

What policy lessons can one draw from this evidence? The fact that agricultural protectionism seems relatively subdued at the moment should not be taken as conclusive evidence that it will not re-emerge. The volume of agricultural trade is shrinking along with that in other sectors. If the recession continues or intensifies, significant pressures will undoubtedly arise for further action to assist agriculture. Vigilance is still needed. Developed countries have been relatively constrained in their actions. The reaction of the major developing countries to further market weakness could hold the key. Any return to tighter import restrictions in the emerging markets could produce a backlash of higher protection in the industrial countries. And the main losers will be smaller countries whose dependence on trade is the greatest.

However, a suitable policy instrument is at hand to make such a return to protectionism less likely. The list of actions taken by governments in response to the economic crisis illustrates well the benefits that would emerge from the speedy completion of the Doha Round. A conclusion based on the draft modalities under consideration in December 2008 would make it much more difficult for countries in the future to increase tariffs, subsidise exports, or support agriculture in ways that impact on trade flows. The structure of trade rules for agriculture is largely in place and seems to have held up well under the strain: taking the next step beyond the Uruguay Round in reducing tariff levels and subsidy amounts would be invaluable to strengthen agricultural trade.[5]

The case for rapid completion of the Doha Round as a way of guarding against a resurgence of agricultural protectionism would be made even stronger if the somewhat weak provisions in the current draft for disciplining export restrictions were strengthened. If import-dependent countries have to agree to limit their own policy space in terms of import barriers for farm products, it would seem desirable to offer them comparable restraints on export taxes and bans. Such an addition could sweeten the deal that is tantalisingly close to agreement.

Ad hoc efforts to make governments agree to avoid protectionist responses to the economic recession, such as debates on trade policies in the G20 Summits, have not so far yielded any firm and legally binding commitments. It is certainly worth leaders' time to continue such efforts. But eventually a swift conclusion of the Doha Round, establishing new formal bindings of lower tariffs and subsidy levels in agriculture that are enforceable in the WTO, would appear to establish the most effective constraint on what otherwise might become an irresistible temptation for the agricultural policy dog to bark again.

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[5] In many ways the benefits in terms of more open agricultural trade of a Doha Agreement along lines currently under negotiation would be greater than those that emerged from the *Agreement on Agriculture*.

APPENDIX TABLE A17.1: POLICY ACTION TAKEN IN THE FOOD AND AGRICULTURE SECTOR SINCE FALL 2008[6]

Country/ Member State	Measure	Date	Source	Comment
1. Border measures in favour of domestic producers				
Argentina	Elimination of export taxes (set at 5 percent in August 2006) for 35 HS tariff lines (Codes 0401; 0402; 0403; 0404; 0405; 0406; and 1901.90.90) 'dairy products', as from 1 January 2009.	6 March 2009	WTO document WT/TPR/OV/W/1	
Belarus	Abolition of the list of 'non-critical' imports. These lists included 16 food and 15 non-food items that would have easier access by Russian firms. Proposed imposition of higher duty on a series of goods, excluding goods made in Russia	3 March 2009	World Bank, International Trade Department, 'Trade-Related Measures Taken Since October 1', April 21 2009	
Brazil	Inclusion of the meat sector in the drawback programme (exception of federal taxes (9.5 percent) on the purchase of national inputs for exportable products)	10 February 2009	WTO document WT/TPR/OV/W/1	
China	Import ban on Irish pork.	December 2008	WTO document WT/TPR/OV/W/1	
China	Elimination of lower Interim Import Tariffs Rates on soybean oil-cake, pork, and neem oil, and resumption of normal MFN rates.	1 January 2009	WTO document WT/TPR/OV/W/1	
China	Cancellation of export licensing administration on silk warm cocoon, and certain silk products.	1 January 2009	WTO document WT/TPR/OV/W/1	
Chinese Taipei	Imposition of a volume-based special safeguard for dried day lilies, from 9 October 2008 to 31 December 2008.	18 November 2008	WTO document WT/TPR/OV/W/1	
Chinese Taipei	Imposition of a volume-based special safeguard for other liquid milk, from 3 December 2008 to 31 December 2008.	6 February 2009	WTO document WT/TPR/OV/W/1	
EC	Anti-dumping duties imposed on preserved fruits from China	December 2008	Gamberoni and Newfarmer (2009)	
EC	Provisional anti-dumping duties (ranging from €23.6 (US$31) to €208.2 (US$272) per tonne net) on imports of 'biodiesel' (CN 3824 90 91; ex 3824 90 97; ex 2710 19 41; ex 1516 20 98; ex 1518 00 91; ex 1518 00 99) originating in the United States, to be effective as from 12 March 2009; and for a maximum period of six months.	11 March 2009	WTO document WT/TPR/OV/W/1	
EC	Provisional countervailing duties (ranging from €211.2 (US$275) to €237 (US$309) per tonne net) on imports of 'biodiesel' (CN 3824 90 91; ex 3824 90 97; ex 2710 19 41; ex 1516 20 98; ex 1518 00 91; ex 1518 00 99) originating in the United States, to be effective as from 12 March 2009; and for a maximum period of four months.	11 March 2009	WTO document WT/TPR/OV/W/1	

[6] In this table, the description of measures reported in the WTO and World Bank lists is taken directly from those lists.

Ecuador	Increased tariffs for imported goods including candy and butter.	27 November 2008	World Bank, International Trade Department, 'Trade-Related Measures Taken Since October 1', April 21 2009	
Ecuador	Tariff increases on 630 tariff lines (accounting for 8.7percent of total lines, covering a wide range of goods, with a view to restore balance-of-payments. (Article XVIII.B of GATT 1994). These measures are intended to be temporary and valid for one year.	Effective as of 22 January 2009	WTO document WT/TPR/OV/W/1	Coverage of agriculture not specified in source
Egypt	Anti-dumping duties on imports of white sugar (imposed in January 2009).	22 February 2009	WTO document WT/TPR/OV/W/1	
India	Removal of export duty and reduction of minimum export price for premium Basmati rice.	20 January 2009	WTO document WT/TPR/OV/W/1	
India	Imposition of 20 percent duty on imported soybean oils	24 February 2009	WTO document WT/TPR/OV/W/1	
India	Export incentives for a variety of exporters, and specific export incentives for textile and leather products.	26 February 2009	WTO document WT/TPR/OV/W/1	Coverage of agriculture not specified in source
Indonesia	Eliminated export duties on crude palm oil and relax export market regulations to help boost exports.	17 December 2008	World Bank, International Trade Department, 'Trade-Related Measures Taken Since October 1', April 21 2009	
Indonesia	New licensing, reporting, and pre-shipment inspection requirements on over 500 goods (including food and beverages).	1 January 2009 and 1 February 2009	WTO document WT/TPR/OV/W/1	
Indonesia	the government has revised import duties on 35 product classifications, including on raw materials for the beverage and chemical industries, (duties reduced) as well as on processed goods for the beverage industry (duties increased)	21 February 2009	World Bank, Department, International Trade 'Trade-Related Measures Taken Since October 1', April 21 2009	
Japan	Special Safeguard measures (SSG) on food preparations of flour, meal or starch, and tubers of konnyaku (from 1 February to 31 March 2009).	13 February 2009	WTO document WT/TPR/OV/W/1	
Mexico	Suspension of preferential tariff treatment, arising from NAFTA, on 89 tariff lines of goods originating from the United States. The World Bank list states that this measure "includes products ranging from fruit and wine to washing machines".	19 March 2009	WTO document WT/TPR/OV/W/1	Coverage of agriculture not specified in source.
Russian Federation	Reduction of meat tariff quotas and increase of non-quota rates for pork (from 60 percent to 75 percent) and poultry (from 60 percent to 95 percent), (measure announced in November 2007, but effective as from 1 January 2009).	1 November 2008	WTO document WT/TPR/OV/W/1	

Russian Federation	Temporary increase of import tariffs (for nine months) on a number of products such as butter and certain types of dairy products (by €0.13 up to €0.35/kg (US$0.2- US$0.5)); milk and dairy cream (by 5 percent up to 20 percent); and rice and milling products (by €0.16 up to €0.23/kg (US$0.2-US$0.3)).	6 November 2008	WTO document WT/TPR/OV/W/1	
Russian Federation	Import ban on pork on supplies from several US facilities which do not comply with technical requirements.	15 February 2009	WTO document WT/TPR/OV/W/1	
Russian Federation	Increase of export duties on hides, skins, and wet-bleu leather postponed, not repealed.	24 February 2009	WTO document WT/TPR/OV/W/1	
South Korea	Imposition of a 4.2 percent tariff rate on imported flour. The item used to be free of tariffs.	26 February 2009	World Bank, International Trade Department, 'Trade-Related Measures Taken Since October 1', April 21 2009	
Turkey	Import tariff increase on a number of products such as wheat and meslin, buckwheat, rye, barley and oats, unprepared cereal straw and husks (from 50 percent to 80 percent); and dried apricots, prunes, apples (from 41 percent to 43.2 percent).	31 December 2008	WTO document WT/TPR/OV/W/1	
Ukraine	Import duty surcharges up to 13 percent, except for "non-critical imports" for a term of up to six months, with a view to restore balance-of-payments (Article XII of GATT 1994). The World Bank list states that on 24 March 2009 "Ukrainian Cabinet of Ministers has decided to cancel a 13 percent extra duty on the import of a number of goods, apart from cars and refrigerators. The law was signed by the president, published in the government newspaper on February 24th 2009, and was supposed to come into effect 10 days after."	As from 7 March 2009	WTO document WT/TPR/OV/W/1	Coverage of agriculture not specified in source. The World Bank list states that "products that fall under 'non-critical import' category include meat and miscellaneous husbandry products, and spirits.
United States	Omnibus Appropriations Act 2009 (H.R. 1105) establishing that "none of the funds made available in this Act may be used to establish or implement a rule allowing poultry products to be imported into the United States from the People's Republic of China". This is reportedly in response to food safety concerns, and is intended to allow time for USDA officials to ensure that imported poultry from China is safe.	11 March 2009	WTO document WT/TPR/OV/W/1	
Uzbekistan	De facto limitation on imports of consumer goods via restricted access to foreign exchange. Possible further delays of conversion for imported consumer goods.	24 February 2009	WTO document WT/TPR/OV/W/1	Coverage of agriculture not specified in source

Vietnam	Announcement of easing of rice export rules including waiving a floor price until early next year and to provide more soft loans for exporters to buy paddy to deal with slowing foreign demand, falling prices and mounting stocks	28 October 2008	World Bank, International Trade Department, 'Trade-Related Measures Taken Since October 1', April 21 2009
2. Application of counter-cyclical measures			
EC	Reintroduction of customs duties on imports of certain cereals (CN Codes: 1001 90 99; 1001 10; 1002 00 00; 1003 00; 1005 90 00; 1007 00 90; 1008 10 00; 1008 20 00) for the 2008/09 marketing year. Since January 2008, tariffs for cereals were suspended (Commission Regulation No608/2008 of 6 June 2008).	22 October 2008	WTO document WT/TPR/OV/W/1
EC	Reintroduction of export refunds for butter, cheese and whole and skim milk powder (as of 19 January 2009). Resumption of market interventions to buy butter and skim milk powder from 1 March 2009.	22 January 2009	WTO document WT/TPR/OV/W/1
United States	Allocations under USDA's Dairy Export Incentive Program for the July 2008 through June 30, 2009, for 68,201 metric tons of non-fat dry milk; 21,097 metric tons of butterfat; 3,030 metric tons of various cheeses and 34 metric tons of other dairy products,	22 May 2009	http://www.fas.usda.gov/scriptsw/PressRelease/pressrel_dout.asp?Entry=valid&PrNum=0081-09
3. Explicit action in favour of domestic consumers or other users			
Ecuador	Import tariff reductions on 3,267 tariff lines covering products such as: raw materials (from 7.6 percent to 3.8 percent) not locally produced.	December 2008	WTO document WT/TPR/OV/W/1
India	Extension and increase of export taxes on hides, skins and wet-blue leather. Import license requirement limiting imports to genuine end user business with back-to-back export orders.	24 February 2009	WTO document WT/TPR/OV/W/1
India	Abolished the 20 percent import duty levied on crude, degummed, soybean oil imposed on 18 November 2008, bringing it on the same level as other crude vegetable oils such as palm, sunflower and rapeseed.	1 April 2009	World Bank Fact 1 Sheet: G20 Countries: Actions on Trade since April 2, 2009 (updated on April 23, 2009)
India	Abolished the import duty on raw and white varieties of sugar. The Finance ministry will soon notify the removal of the 60 percent tax. The duty exemption is valid until July 31.	13 April 2009	World Bank Fact Sheet: G20 Countries: Actions on Trade since April 2, 2009 (updated on April 23, 2009)
Indonesia	New regulation stipulating that exports of crude palm oil, coffee, rubber, and cocoa with an export value exceeding US$1 million must be supported by letters of credit issued by domestic banks.	5 March 2009	WTO document WT/TPR/OV/W/1

Japan	Lifted the ban on Chilean pork, which was introduced last year after detecting dioxin in the pork last year.	17 April 2009	World Bank Fact Sheet: G20 Countries: Actions on Trade since April 2, 2009 (updated on April 23, 2009)	
Philippines	Tariff reduction on wheat and meslin to 0 percent for a period of six months, effective from 22 December 2008.	7 November 2008	WTO document WT/TPR/OV/W/1	
Philippines	Reduction of import tariffs on several products, mainly not locally produced. Reduction of MFN tariffs from 3 percent to 1 percent on dried distillers grain soluble and soybean meal.	10 February 2009	WTO document WT/TPR/OV/W/1	
South Korea	South Korea agreed to open up to US beef imports after Washington pledged to raise safety standards, boosting prospects for a sweeping trade deal ahead of a summit between leaders of the allies later in the day	18 April 2009	World Bank Fact Sheet: G20 Countries: Actions on Trade since April 2, 2009 (updated on April 23, 2009)	
Tunisia	Reduction of customs duties under economic stimulus plan.	23 December 2008	WTO document WT/TPR/OV/W/1	Coverage of agriculture not specified in source
Kazakhstan	Reduction of import tariffs on equipment and raw materials that are not locally produced (but with increase of import tariffs on finished goods, competing with local production).	28 December 2008	WTO document WT/TPR/OV/W/1	Coverage of agriculture not specified in source.
4. Stimulus programmes targeting agriculture				
Belgium	Flemish region brings forward an €15.5 million aid package for dairy farmers March 2009 Press reports Brazil Provisions to increase supply of rural credit Press reports Canada Provincial support program of the Government of Saskatchewan, CAD71 million, for cattle and hog producers	February 2009	Press reports	
China	Government to increase agricultural subsidies by 120 billion yuan, increasing the total amount envisaged in 2009 to 220 billion yuan. This is within the amount permitted under China's WTO obligations. Bridges reports that "China's response to the global financial crisis, a stimulus package worth US$ 585 billion over two years, includes a five-fold increase in spending on agriculture, boosting it from US$18 billion to US$106 billion. The government is expected to spend nearly US$ 26 billion to stock commodities such as grains nd edible oils".	2 February 2009	World Bank, International Trade Department, 'Trade-Related Measures Taken Since October 1', April 21 2009 Bridges Weekly Trade News Digest, Vol 13 no 9, 11 March 2009	

EU	Extra expenditure of around €1 billion for rural development under the EU economic recovery plan January 2009 Press reports France €250 million programme of income support, debt relief and fuel rebates for farmers November 2008 Press reports Germany €300 million reduction in tax on diesel used in agriculture	May 2009	http://www.bmelv.de/cln_044/nn_750578/DE/12-Presse/Pressemitteilungen/2009/05-95-AI-Agrardiesel.html
India	Increase in the Minimum Support Price for cotton paid to local farmers.	14 February 2009	WTO document WT/TPR/OV/W/1
Indonesia	National action plan, including subsidised fertilisers, farm credits with subsidised interest, guaranteed farm gate price, domestic food stocks	December 2008	Press reports
Poland	Easing of credit for agriculture		Press reports
Russia	Various measures improving credit conditions for agriculture	January 2009	Press reports
Spain	Programme for farms and agro-food businesses to facilitate access to subsidised credit	January 2009	Press reports
Sri Lanka	Tea growers to be granted a fertiliser subsidy of up to Rupees. 30 billion	22 January 2009	World Bank, International Trade Department, 'Trade-Related Measures Taken Since October 1' April 21, 2009

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18

Protectionism in Textiles and Apparel

STACEY FREDERICK AND GARY GEREFFI

1. INTRODUCTION

This chapter seeks to analyse the policy responses and trade implications that have occurred in the textile and apparel (TA) sectors in response to the current economic crisis. The TA industries have a long history of protectionism through the *Multi-fibre Arrangement* (MFA) that governed world trade in textiles and apparel from 1974 to 2004. Therefore, section 3 analyses recent TA actions from two perspectives: 1) the total protectionist actions taken in all industries in recent months; and 2) the historical trends in TA protectionism. Furthermore, this section categorises protectionist measures into three groups: tariff barriers and trade remedies, non-tariff barriers, and government support and subsidies. We provide an overview of the specific actions recently taken by governments aimed at reviving or protecting their TA industries from foreign competition. In the final two sections, trade patterns over time are discussed and analysed, and conclusions and recommendations are provided.

2. TWO PERSPECTIVES IN THE TEXTILE AND APPAREL PROTECTIONIST DEBATE

Both short-term and long-term perspectives are needed to evaluate protectionist trends in the TA sectors. In the short term several statistics indicate a recent upswing in the number of tariff and non-tariff actions that have taken place in all industries. According to the World Bank, from the beginning of the financial crisis (October 2008) through to February 2009, trade officials have proposed and (or) implemented roughly 78 trade measures[1] (Gamberoni and Newfarmer, 2009). Of these, 66 involved trade restrictions and 47 trade-restricting measures have taken effect (see Table 18.1 for specific measures). In general, developed countries are relying on industry subsidies in response to the crisis, and developing countries are more often increasing tariffs (Gamberoni and Newfarmer, 2009; Baldwin and Everett, 2009). In both cases, there has been a rise in anti-dumping cases and in agricultural subsidies (Baldwin and Everett, 2009).

[1] These figures do not include anti-dumping cases.

Table 18.1: *Trade-restricting Measures, October 2008 to February 2009*

Trade Restricting Measures	Developing	Developed	Totals
Subsidies and Support Packages	11 (31%)	12 (100%)	23
Tariff Increases	17 (49%)		17
Non-tariff Measures	4 (11%)		4
Import Bans	3 (9%)		3
Total	35	12	47

Source: Gamberoni and Newfarmer (2009)

However, in the case of the TA sectors, a longitudinal perspective should also accompany analysis of the recent trends. When compared with the last four decades, one can claim that the number of trade-restricting actions is drastically reduced. Since, October 2008, more governments in garment-importing countries have removed barriers to the clothing trade than ever before and the last six months have represented the most widespread – and under-reported – abolition of protectionist trade barriers than any period on record. The report faults exporters who are 'unable or too slow to exploit these changes' and thus they are finding it easier to blame their governments or non-existent protectionist barriers for their lack of success[2].

3. PROTECTIONIST MEASURES

Protectionist measures are divided into tariff barriers, non-tariff barriers, and government subsidies and support packages. Tariff measures include tariff increases and trade remedies. Non-tariff barriers include policies that encourage domestic production by creating obstacles to imports (such as import licensing) and incentives for domestic production (such as government procurement or trade agreements with rules of origin). For each of the three classifications, the actions are summarised below, and the specific cases (countries, dates, products, and actions involved) are available upon request.

3.1 Tariff barriers and trade remedies

Binding tariffs and applying them equally to all trading partners are the goals for international trade within the World Trade Organization (WTO). Yet this does not always happen because not all countries apply their bound tariff rates, thus allowing them to increase their applied tariff rates. Furthermore, there are several agreements that allow for exceptions or trade remedy actions to be taken if potentially threatening or unfair trade practices are suspected. Trade remedy actions include:

[2] Source: just-style.com. (2009). Analysis: Do Stimulus Packages Help the Garment Trade? Just-Style Weekly (468). Retrieved from http://www.just-style.com/article.aspx?id=103915&lk=dm

Anti-Dumping (AD) investigations and measures: Dumping occurs if a company exports a product at a price lower than the price it normally charges in its home market. The WTO AD Agreement allows a country to undergo an investigation and add an extra duty (AD duty) to an imported product in order to bring the price closer to a normal value or remove the injury to the domestic industry in the importing country.

Subsidies and countervailing (CV) duties: The WTO *Agreement on Subsidies and Countervailing Measures* (SCM) disciplines the use of certain subsidies, and regulates the actions countries can take to counter the effects of subsidies. The Agreement only applies to specific subsidies – that is, a subsidy available to an enterprise, industry, group of enterprises, or group of industries in the country (or state, etc.) that gives the subsidy. They can be domestic or export subsidies. To overcome the effect of subsidies, a CV duty can be applied to an imported product after an investigation has taken place.

Safeguards: Emergency measures to limit imports temporarily, designed to 'safeguard' domestic industries.

Table 18.2 shows the total number of tariff increases and trade remedy investigations and measures that have recently occurred in the TA sectors. Table 18.3 compares the number of textile trade remedy actions to the total number of actions taken by all industries over the same period, and with respect to the total number of actions over time.

Table 18.2: *New Textile and Apparel Tariff Increases and Trade Remedy Cases: Countries and Actions, 2008–2009 (actual date range in parenthesis)*

Country	Tariffs and Trade Remedies								
	Raise Tariffs (2008–2009)	Anti-dumping Actions				CV Measures (2008)		Safeguards (2008–2009)	
		Investigation (7/08–12/08)		Measure (2008)				Invest.	Measure
		R	E	R	E	R	E		
United States				1		1			
Canada									
EU-27*			2						
China,			6		4		1		
Taipei,			3						
Hong Kong			1						
India	X	3	3		1				
Brazil	X	6		2					
Argentina		8							
Egypt	X							1	1
Turkey		5		7				1	1
Bangladesh					1				
Vietnam					1				
Indonesia			3		1				
Pakistan		1							
Thailand			1		1				
Malaysia					1				
Iran			1						
Israel			1						
Saudi Arabia			1						
Ecuador	X								
Peru								1	
Paraguay									
Belarus			1						
Totals	4	23		10		1		3	2

R: Reporting country
E: Exporting country under investigation
*: Anti-dumping investigations were for Austria and Italy only

Table 18.3: *Total Numbers of New Trade Remedy Investigations and Measures versus TA-related Actions in the Past and Present, 1995–2009 (actual date range in parenthesis)*

Anti-dumping Actions		Totals	Textiles (%)
2008	Total Investigations[3]	208	
2008	Textile Investigations[1]	39	18.8
2008 (7/1–12/31)	Total Investigations[4]	120	
2008 (7/1–12/31)	Textile Investigations[2]	19	15.8
2009 (1/31–3/25)	Total Investigations[2]	29	
2009 (1/31–3/25)	Textile Investigations	~5	
2008	Total Measures[1]	139	
2008	Textile Measures[1]	10	7.2
1995–2008	Total Investigations	3,427	
1995–2008	Textile Investigations	271	7.9
1995–2008	Total Measures	2190	
1995–2008	Textile Measures	183	8.4
Countervailing Duty Actions			
2008	Total Investigations[3]	14	
2008	Textile Investigations[5]	0	0
2008 (7/1–12/31)	Total Investigations[2]	6	
2008 (7/1–12/31)	Textile Investigations [3]	0	0
2008	Total Measures[3]	11	
2008	Textile Measures[3]	1	9.0
2009 (1/31–3/25)	New Investigations[2]	3	
2009 (1/31–3/25)	Textile Investigations	TBD	
1995–2008	Total Investigations[3]	215	
1995–2008	Textile Investigations[3]	13	6.0
1995–2008	Total Measures[3]	128	
1995–2008	Textile Measures[3]	6	4.7
Safeguard Actions			
2008	Total Investigations[3]	11	
2008	Textile Investigations[6]	2	18.2
2008 (11/12)	Total Measures[4]	6	
2008 (11/12)	Textile Measures[4]	2	33.3
2009 (3/25)	Total Investigations[3]	6	
2009 (3/25)	Textile Investigations	1	16.7
1995–2008	Textile Investigations[4]	4	
2008	Textile Investigations[4]	2	50.0
1995–2008	Textile Measures[4]	3	
2008	Textile Measures[4]	2	66.7

[3] (WTO, 2009a).
[4] (Lamy, 2009).
[5] WTO (2009b).
[6] WTO (2009c).

Import Tariff Increases

There have been four country cases related to increasing tariffs for products in the textile and apparel sectors. All of these cases are from developing countries (India, Brazil, Ecuador, and Egypt), primarily targeted at other developing countries. Each concerns textile products (yarn or fabric) rather than apparel, and they apply to cotton rather than synthetic products.

Anti-Dumping (AD) Investigations and Measures

In 2008, there were 208 AD investigations and 139 AD measures. Of these, 39 (18.8 percent) of the investigations and 10 (7.2 percent) of the measures were in the textile and related articles sector[7] (WTO, 2009a). According to the WTO report, in the second half of 2008 (1 July to 31 December), there were 120 AD investigation initiations with 19 related to textiles. Overall, it indicated that the total number of AD investigations increased by 27 percent in 2008 compared to 2007 (Lamy, 2009).

Looking at historical patterns of AD actions, between 1995 and 2008, there were 271 AD investigations and 183 AD measures in the textiles and related articles sector (WTO, 2009a). In Table 18.4, the recent trends in AD actions in the TA industry are compared to historical trends. According to these data, 2008 represented the highest number of investigations ever reported in one year, and the highest percentage of investigations related to textiles (19 percent). The total number of investigations increased by 255 percent in 2008 compared to 2007. The trend is not as obvious in textile measures because of the time-lapse between carrying out the investigation and imposing a measure. Therefore, 2009 is likely to see a spike in textile-related AD measures.

Overall, the World Bank report indicated that developing countries accounted for the majority of investigations (led by India with 29 percent), and developed countries accounted for the greatest number of duty impositions (primarily the United States and the European Union) (Gamberoni and Newfarmer, 2009). Yet, this was not entirely the case in the TA sector. In TA, all of the investigations and all but one of the measures were initiated by just five developing countries: Turkey, Brazil, Argentina, India, and Pakistan (see Table 18.2). Note that AD actions are only being carried out by a handful of countries and, like tariff increases, they are also entirely for textile products.

Countervailing (CV) Duty Actions

In the second half of 2008 (1 July to 31 December), there were six new CV investigations (Lamy, 2009) and in all of 2008, there were 11 total CV duty measures (WTO, 2009b). None of the investigations and only one of these measures involved the textile sector (WTO, 2009b). The CV measure was reported in Au-

[7] Textiles and related articles is sector XI in WTO reports.

Table 18.4: *Total versus Textile Sector Anti-dumping Investigations and Measures, 1995–2008*

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Textile Investigations	1	23	8	28	34	17	26	6	14	21	27	16	11	39
Total Investigations	157	225	243	257	356	292	366	312	232	214	200	202	163	208
Percentage of Textiles (%)	1	10	3	11	10	6	7	2	6	10	14	8	7	19
Textile Measures	4	8	9	2	21	24	8	29	2	14	13	23	16	10
Total Measures	119	92	125	170	186	228	169	215	220	152	132	137	107	138
Percentage of Textiles (%)	3	9	7	1	11	11	5	13	1	9	10	17	15	7

Source: (WTO, 2009a).

gust 2008 by the United States against China for laminated woven sacks, according to the semi-annual SCM report for the United States (WTO Document: G/SCM/N/185/USA). There were no CV investigations in the textile sector in 2008 (WTO, 2009b). The investigation for the only measure implemented in 2008 was initiated in 2007, so this action is not directly associated with the economic crisis.

Safeguards

In 2008, there were 11 total safeguard investigations (Lamy, 2009) and six safeguard measures[8] (WTO, 2009c). Of these, two of the investigations and two of the measures were related to textiles: Egypt and Turkey. In 2009 (January to 25 March), there have been six safeguard investigations (Lamy, 2009). Of these, one is related to textiles: Peru. Again, all are for cotton textile products. This is definitely an increase for the textile sector. Between 1995 and 2008,[9] there were only four investigations and three measures in the textile sector.

China Safeguards

As part of China's Accession to the WTO, a special textile safeguard provision was signed that allowed countries to place quotas on TA imports from China through to the end of 2008. Three countries or regions (the United States, the European Union, and Turkey) implemented such quotas. These quota actions are not directly related to the current economic crisis *per se*. But they represent an important change in a pre-existing policy that is likely to influence future trade patterns and policy responses over the next several months.

[8] Data are only available until November 11, 2008.
[9] Actual dates: 25 March 1995 until 12 November 2008.

3.2 Non-tariff barriers

The following non-tariff barriers represent both new and existing actions countries have in place either to restrict imports or promote domestic consumption. The first barrier relates to new procedures that are designed to make the international trade process more difficult and thus restrict imports. The second action, social compliance, is a special case. With the economic crisis taking a toll on operating margins around the world, firms will be looking for all possible measures to increase their bottom lines. It will be important to make sure these budget cuts are not taken at the expense of human health, safety, or the environment.

The final two actions, *Generalized System of Preferences* and the *Government Procurement Agreement*, are both schemes within the WTO designed to encourage international trade, and participation can actually be seen as a step towards trade liberalisation. However, each country's participation should be monitored because both programs have mechanisms that can be used to promote domestic consumption within the scheme.

Trade Procedure Import Barriers

There were two cases of non-automatic import licensing and one case of restricted port access that include provisions for the TA sectors (Indonesia and Argentina). At this time, import procedural hurdles do not seem to be a major method to protect TA related domestic industries.

Regarding trade procedures, it is important to keep in mind that the TA industries are two of the most complicated sectors, even without imposing specified barriers. The number of materials and configurations that can be combined to create components or final products is arguably endless. As a result, simply acquiring the knowledge or financial means to navigate TA policies and procedures are barriers in themselves. Any simplification or standardisation of international or national trade processes, labelling, and certification schemes will facilitate trade and enable developing countries to participate.

Social and Environmental Compliance

Only one instance of reduced social or environmental protection was noted. In China, the central government has reportedly already relaxed its first workplace-protection requirements introduced in January 2008 under the Labor Contract Law. In order to help businesses, the government has permitted local authorities to freeze minimum-wage levels and to reduce or suspend employers' social-insurance contributions.

Social and environmental compliance are of the utmost importance for the TA industries, due to the labour intensity of the apparel industry and the environmental impacts of the textile industry (that is, high energy usage and wastewater). In recent years, the TA industries have led the way in creating standards to hold firms and countries accountable for their social and environmental actions. Any changes in this category should be carefully monitored, because re-

laxing current standards may trickle down to other industries, and non-compliance has the potential to create the most widespread, long-lasting repercussions.

Generalised System of Preferences (GSP)

The GSP is one of the allowable exceptions to the standard, most favoured nation (MFN) tariff that can be granted for developing and least-developed countries. This program is important to the TA sectors, because a large percentage of the gross domestic product and export incomes of developing countries depend on the apparel (and to a lesser degree, textile) industries. Currently there are 13 countries that grant GSP preferences: Australia, Belarus, Bulgaria, Canada, Estonia, EU27, Japan, New Zealand, Norway, Russia, Turkey, Switzerland, and the United States (UNCTAD, 2006). The United States extends GSP tariff preferences for most products, but it does not currently extend them to most TA products.[10]

The country granting GSP benefits chooses the level of the tariff reduction, the countries that receive the reduction, the rules of origin required, and the products included. In several ways, the GSP program is similar[11] to a free trade or preference agreement, so that changes in these agreements should also be monitored.

There was one new case of modifying the rules of origin requirements to promote domestic consumption. In 2008, Canada began offering an *Outward Processing Remission Order* that further reduces the GSP tariff level for developing countries if they use Canadian textiles to manufacture apparel exports destined for Canada.

Government Procurement

The WTO has a *Government Procurement Agreement* (GPA) whose members agree to apply equal opportunities to all countries for products purchased from each government's budget with allowable provisions for domestic production if a country believes national security is an issue (that is, military). Currently there are 13 members.[12] Increasing the number of countries that adhere to this agreement may be important for the TA industries, due to the investments planned for infrastructure developments in several stimulus programs with planned government spending (see below).

3.3 Government support and subsidies

Table 18.5 and the following section summarise the countries with textile-related government support, including: agricultural subsidies, general subsidies with tex-

[10] A few handicrafts receive GSP rates, and the *African Growth and Opportunity Act* (AGOA) is similar to granting GSP benefits, although rules of origin and quotas apply. There is a bill pending in US Congress (*Tariff Relief Assistance for Developing Economies Act of 2009*) to extend GSP benefits to the 14 least developing countries.

[11] The major difference is that the GSP program is non-reciprocal. Tariff preferences are unilateral.

[12] Members include Canada, EU27, Hong Kong, Iceland, Israel, Japan, Korea, Liechtenstein, the Netherlands with respect to Aruba, Norway, Singapore, Switzerland, and the United States.

tile funding opportunities, actionable or potentially illegal subsidies, and direct government stimulus funding for textiles.

Table 18.5: *Textile-related Government Support and Subsides, 2008-2009*

Country	Government Support: Subsidies and Stimulus			
	Agricultural Subsidies	General Subsides	Actionable Subsidies	Stimulus Support
United States	X			X, C
EU-27	X	X		C
Japan	X			
China	X	X	X	X
India			X	X
Argentina		X	X	
Korea	X			X, C
Bangladesh		X		
Sri Lanka		X		

From various sources.
C: Indicates stimulus support is for automotive component suppliers

Agricultural Subsidies

Provisions affecting agricultural products should be mentioned with regard to the TA industries, because this category includes the raw materials (such as cotton, wool, silk, hemp, flax, etc.) used in many textile products. Agricultural products have separate provisions from those in place for trade in manufactured goods, which allow for several industry-specific subsidies. Therefore, protection to agriculture may not even require new measures because the existing subsidies automatically provide for increases in subsidies with declines in agricultural prices. For example, many countries, including the European Union, the United States, Japan, and South Korea have subsidy programs that increase direct payments to producers when commodity prices fall (Gamberoni and Newfarmer, 2009). Agricultural subsidies may thus provide a loophole for subsidies to textile manufacturers who purchase these raw materials.

General Subsidies with Textile Provisions

Several countries (including the European Union and China) extend subsidies that are applied equally to all industries, thus providing opportunities to benefit their domestic TA sectors. These types of subsidies are allowed in the WTO and are not considered protectionist measures; but it is important to be aware of these programs because they may later be changed or interpreted by another country as a WTO-prohibited subsidy.

Actionable Subsidies

China has the most notable cases of potentially providing WTO-prohibited subsidies. The United States has filed three disputes in the last three years against

Chinese domestic subsidies aimed at promoting (domestic) Chinese brands, providing export subsidies, import substitution, and most recently export duties and quotas to promote the downstream manufacturing industries of raw materials found in China. Potential evidence of illegal subsidies in India and Argentina were also identified (little information was found on these cases and no investigations have occurred).

Recent Government Support and Stimulus Packages

Several countries have created stimulus packages that will indirectly assist the textile sector through government funding allocated for final products that use textiles as a component, such as automobile manufacturing, construction, and infrastructure investments. Three countries, the United States, Paraguay, and now China have enacted 'buy national' requirements for government spending under these packages that is likely to have an adverse effect on international trade. China's decision to require domestic production is the most notable because the provision was not originally part of their stimulus package (added in May 2009) and China does not adhere to the GPA. This reversal may spark other countries to follow the trend.

China is also the only significant example of recent government support specifically for the TA industry. In 2009, China announced a three-year stimulus package to encourage textile enterprises to focus on domestic demand, develop rural markets, and cultivate home-grown brands. The general goal is to maintain stable textile production and sales to keep employment.

4. INTERNATIONAL TRADE PATTERNS

Several important international TA trade data tables and figures are presented in the Appendix. These are:

Table A18.6 includes only the top 15 TA-exporting countries for 2007.
Table A18.7 includes apparel statistics for China's top 10 export markets for three years (1997, 2002, 2007). China is the world's largest apparel exporter.
Figures A18.1 to A18.3 depict the regional apparel import patterns for the three largest apparel-importing countries (the United States, EU-15, and Japan).
Figures A18.4 to A18.6 depict the changes in textile exports of these three countries.

These trade patterns show the impact of reduced regulations in the TA sectors, especially after the removal of quotas. After the MFA quota phase-out in 2005, two major trends occurred in apparel (and to a lesser degree, textile) sourcing. First, the world's three top apparel importers (the United States, the European Union, and Japan) all faced a heightened consolidation of global apparel exports, with China dramatically increasing its share of the world's biggest import markets. With no quotas to limit apparel imports following the expiry of the WTO Chinese safeguards (after 2007 in the European Union and 2008 in the United States), China has clearly emerged as the leading apparel producer in the world.

Second, China's impressive pattern of export diversification in apparel means that it does not depend on any specific region to sustain its global market share, unlike the leading apparel-importing countries, which are dependent on China as their key supplier. In 2007, China's top apparel-export markets were the European Union 15 (17.4 percent), the United States (16.3 percent), and Japan (14.3 percent), which together represented just under one-half (48 percent) of China's total apparel exports (see Table 18.7). By contrast, in 2007, China accounted for 34.5 percent of apparel imports in the United States, 28.5 percent in the European Union 15, and an astronomical 83 percent of Japan's apparel imports (Appendix: Figures 18.1 to 18.3). Given this striking asymmetry in China's role in global apparel markets, it might be difficult for one country to combat potentially illegal Chinese subsidies. If allegations of protectionism are true, several countries may need to join forces to confront the issue.

After consolidation, the other trend is the growing importance of regionalisation in TA-sourcing networks. This is most clearly evident in the European Union's sourcing patterns, but is also evident in both the United States and Japan (Appendix: Figures 18.1 to 18.6).

5. TRENDS, CONCLUSIONS, AND RECOMMENDATIONS

The overall trends, conclusions, and possible recommendations for the future in the TA industries can be summarised as follows.

5.1. Recent Trends and Conclusions:

Trade Remedies: Overall, the number of textile cases in 2008 was high (especially in AD investigations and safeguards) with respect to both the number of recent cases and historical trends. Even though the AD percentages were high, they were initiated by only a handful of reporting countries against a small number of exporting countries. Furthermore, the list of products being protected is limited to a relatively small set of textile items. Finally, we should note that many of the countries initiating actions do not play a significant role in international textile trade (Appendix: Tables 18.6 and 18.7).

Since it can be costly and time consuming to investigate and implement trade remedies or non-tariff barriers, these measures may be prohibitive for many of the developing countries to implement effectively. Therefore the magnitude of these measures is likely to be much less than in the past when developed countries with more money and power were initiating them. When economic conditions improve, this trend is likely to decrease.

Non-tariff barriers: Imposing new, non-tariff barriers, does not appear to be a significant trend compared to the total number of actions for all industries or for the TA industries. The issue of social and environmental compliance is likely to grow in importance, and it should be encouraged as a way to foster social and economic upgrading in developing economies.

Government subsidies and support: In comparison to recent investments for other industries (such as finance and automotive), the number of textile-specific government support cases is very low. China is the only country with potentially significant investments planned for the textile industry, and these should be carefully monitored. Equally important have been changes to existing, allowable agricultural subsidies. Even though (in most cases) these are not granted directly to companies in the TA sectors, subsidising textile raw materials is a way to protect legally an important piece of the TA supply chain. Whereas agricultural subsidies do not appear to be a significant issue now, they provide a potential loophole to protect and support manufacturers that purchase domestic cotton or other natural fibres.

5.2. *Historical Trends and Conclusions:*

When recent trends are compared to historical TA protectionist actions, two shifts in the centre of gravity are evident:

> The first shift is from developed to developing countries as the initiators of trade actions. In the past, the European Union and the United States were the forces promoting and implementing trade-restricting policies. Yet in the most recent actions, developing countries have been the ones responsible for initiating trade barriers, primarily aimed at limiting imports from other developing countries. Developed countries are reducing their trade remedy actions and they are moving toward a greater use of free trade agreements.
>
> The second shift is from protecting the apparel industry to protecting the textile and raw material industries. Almost all of the recent trade-restricting measures seek to protect textile rather than apparel producers. In the past, the major apparel-importing countries (developed economies, such as the European Union and the United States) were the primary advocates for restrictive trade measures, mainly aimed at protecting the apparel rather than the textile industry.

Now that these restrictive policies have expired and these countries' TA production capacities are drastically reduced, three new trends can be detected:

> *Regionalisation:* Regional sourcing is becoming more important and there are an increasing number of bilateral and multilateral agreements. Countries that do not actively pursue such agreements (other than China) will find it difficult to compete in the future. This trend is expected to intensify with new concerns about protecting the environment. The European Union is the most notable example of changing its focus from protectionist policies to developing regional sourcing networks with Eastern and Central Europe. For instance, in April 2009, the European Union abolished the anti-dumping duty on bed linens from Pakistan[13] historically one of the most-protected products by the

[13] Source: just-style.com. (2009). Analysis: Do Stimulus Packages Help the Garment Trade? Just-Style Weekly (468). Retrieved from http://www.just-style.com/article.aspx?id=103915&lk=dm

European Union (Adhikari and Yamamoto, 2007), especially from India and Pakistan (Adhikari and Weeratunge, 2007). Furthermore, two more countries were added to the European Union in 2007, and several other trade partnerships (Euro-Mediterranean Partnerships), preference schemes (GSP+), and customs unions (Turkey) have been created.

Focus on China: After all quotas were removed in 2008, China clearly increased its role as the leading apparel exporter and also as a textile exporter. The quota system actually encouraged China to develop the capacity to produce every item in the TA supply chain (Gereffi and Memedovic, 2003). Now China is moving up the value chain into higher-value activities such as branding and marketing. In the past, these value-adding activities were seldom the target of protectionist measures, because only a few countries (primarily the United States and the European Union) had the skills and market power to compete in this arena. Currently, the United States has switched to monitoring China's recent investments in developing domestic brands because this now poses much more of a threat to US apparel marketers than to pure textile and apparel manufacturers. This trend is similar to the previous lack of protection directed towards the textile industry. Since textiles are more complex than apparel, fewer countries had the capacity to integrate backwards from apparel to textiles, resulting in less competition and fewer protectionist measures.

Diversification: Japan is taking measures to diversify its sources of apparel import supply in order to move away from its extreme dependence on China. Japan would like to cut China's import market share of textiles and apparel to only 50 percent. Japan is working with factories in Bangladesh as well as Indonesia and other nations within the Association of Southeast Asian Nations (ASEAN) to take advantage of their free trade agreement there [14],[15]

In summary, compared to the last four decades, the current situation in the TA industries is much improved and the environment is more liberal than before. If the comparison is extended to the early 1970s, when the MFA was introduced, the situation today represents the most 'liberal' period for TA in several decades. In the light of this, we see very few significant elements of protectionism compared to the past.

5.3. General Recommendations

- For the developed economies (the United States, the European Union, and Japan), the vast majority of apparel production has already moved offshore.

[14] Source: just-style.com (2009). Japan: China sourcing cuts could raise costs for US, EU buyers. Just-style, March 4. Retrieved from http://www.just-style.com/article.aspx?id=103487&lk=dm

[15] Source: Japan mulls importing more Indonesian textiles (2009). Jakarta Globe; February 24 Issue. Retrieved from FashionNetAsia.com: https://www.fashionnetasia.com/industryupdate/details.aspx?lang=0&sid=22&pid=2254

Therefore, there is no domestic apparel industry left to protect. The main emphasis for these economies should be to strengthen innovation in their TA sectors, including mass-customisation manufacturing, high-quality fabrics, and technical textiles for non-traditional products (such as medical applications, the construction industry, and new textile materials).

- Regional sourcing is of growing importance in the TA industries, and it is being used extensively by the United States, the European Union, and Japan to reduce their reliance on apparel imports from China. Rules of origin should be expanded to include regional trading blocs that include the capability to produce full-package garments.
- Encourage relaxed rules of origin to facilitate TA exports from the least developed countries, such as those in sub-Saharan Africa. Apparel assembly is the lowest rung on the textile-apparel supply chain and one of the best ways to stimulate export-oriented industrialisation for many poor nations. A country will develop the capacity to manufacture garments long before fabric and yarn, and thus in many cases requiring 'double transformation' (in both apparel and textiles) in a country is not feasible.
- China is the world's largest producer of textile and apparel products. While it has been accused of various alleged trading abuses, such as using export subsidies to advantage domestic producers unfairly, it is also under great pressure, as a result of the recent economic crisis to stabilise TA production and sales to maintain employment. China's trade actions should be closely monitored, but the country should also be encouraged to sustain its labour reforms and to continue its investments in the sector aimed at promoting social as well as economic upgrading.
- Social and environmental compliance is emerging as a very important issue for the TA industries due to the labour intensity of the apparel industry and the environmental impact of the textile industry (for example, high usage of energy and waste water). Many of the leading global retailers and manufacturers of TA products are establishing campaigns to create more sustainable supply chains and products, and they are in a strong position to promote improvements in labour and environmental conditions in the most important developing-country exporters, such as China, India, Bangladesh, Indonesia, and Pakistan. These social and environmental efforts should be maintained and strengthened.

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APPENDIX: INTERNATIONAL TRADE STATISTICS: TABLES AND CHARTS

Table A18.1: *Top 15 Textile and Apparel Exporting Countries or Regions: 2007*

Country	Share in World Textile Exports (%)	Share in World Apparel Exports (%)
EU27	33.9	29.9
Extra-EU27 exports	10.0	7.2
China	23.5	33.4
United States	5.2	1.2
Korea	4.4	
Taipei, Chinese	4.1	
India	4.0	2.8
Turkey	3.7	4.1
Pakistan	3.1	1.1
Japan	3.0	
United Arab Emirates	1.7	
Indonesia	1.6	1.7
Thailand	1.3	1.2
Canada	1.0	
Mexico	0.9	1.5
Hong Kong (domestic exports only)	0.2	1.4
Bangladesh		2.9
Vietnam		2.1
Morocco		1.0
Tunisia		1.0
Sri Lanka		1.0
Top 15 Total:	91.4	86.3

Source: WTO, 2008

Table A18.2: *China Apparel Exports: 1997, 2002, 2007 (values in US$ millions and percentages (%))*

1997: Top Apparel Markets		
Hong Kong	$11,601	36.5
Japan	$7,757	24.4
United States	$3,587	11.3
Germany	$962	3.0
Russian Fed.	$884	2.8
Repepublic of Korea	$737	2.3
Australia	$536	1.7
United Kingdom	$377	1.2
Panama	$352	1.1
Italy	$341	1.1
World	$31,803	
Top Ten Markets	$27,135	85.3

1997: Top Apparel Markets (using EU-15)		
Hong Kong	$11,601	36.5
Japan	$7,757	24.4
United States	$3,587	11.3
European Union 15	$2,868	9.0
Russian Federation	$884	2.8
Republic of Korea	$737	2.3
Australia	$536	1.7
Panama	$352	1.1
Canada	$318	1.0
Poland	$315	1.0
World	$31,803	
Top Ten Markets	$28,955	91.0

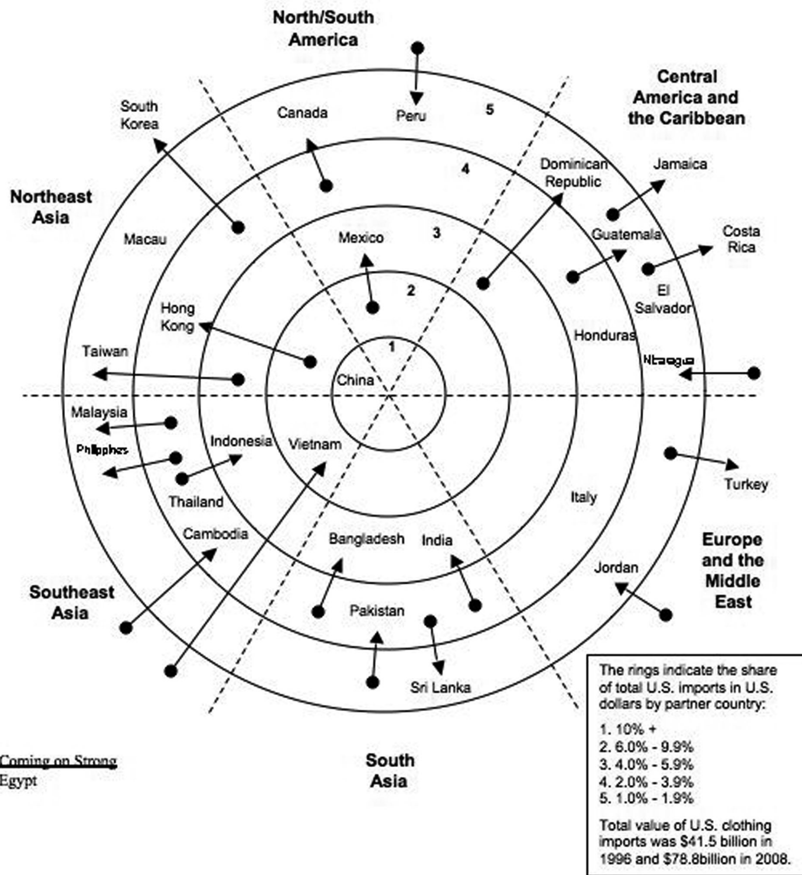
2002: Top Apparel Markets		
Japan	$11,197	27.1
Hong Kong	$7,084	17.2
United States	$5,325	12.9
Republic of Korea	$2,250	5.4
Russian Fed.	$1,300	3.1
Germany	$1,120	2.7
Australia	$1,027	2.5
United Kingdom	$754	1.8
Canada	$731	1.8
Mexico	$618	1.5
World	$41,302	
Top Ten Markets	$31,405	76.0

2002: Top Apparel Markets (using EU-15)		
Japan	$11,197	27.1
Hong Kong	$7,084	17.2
United States	$5,325	12.9
European Union 15	$4,672	11.3
Rep. of Korea	$2,250	5.4
Russian Federation	$1,300	3.1
Australia	$1,027	2.5
Canada	$731	1.8
Mexico	$618	1.5
Singapore	$617	1.5
World	$41,302	
Top Ten Markets	$34,821	84.3

2007: Top Apparel Markets		
United States	$18,791	16.3
Japan	$16,498	14.3
Hong Kong	$9,336	8.1
Russian Federation	$8,884	7.7
Germany	$4,766	4.1
Canada	$3,849	3.3
United Kingdom	$3,500	3.0
Republic of Korea	$3,379	2.9
Singapore	$3,111	2.7
Italy	$2,600	2.3
World	$115,238	
Top Ten Markets	$74,712	64.8

2007: Top Apparel Markets (using EU-15)		
European Union 15	$19,996	17.4
United States	$18,791	16.3
Japan	$16,498	14.3
Hong Kong	$9,336	8.1
Russian Federation	$8,884	7.7
Canada	$3,849	3.3
Republic of Korea	$3,379	2.9
Singapore	$3,111	2.7
United Arab Emirates	$2,516	2.2
Australia	$2,158	1.9
World	$115,238	
Top Ten Markets	$88,517	76.8

Source: UN Comtrade (1997, 2002, 2007): SITC code 84 rev. 3: China exports.



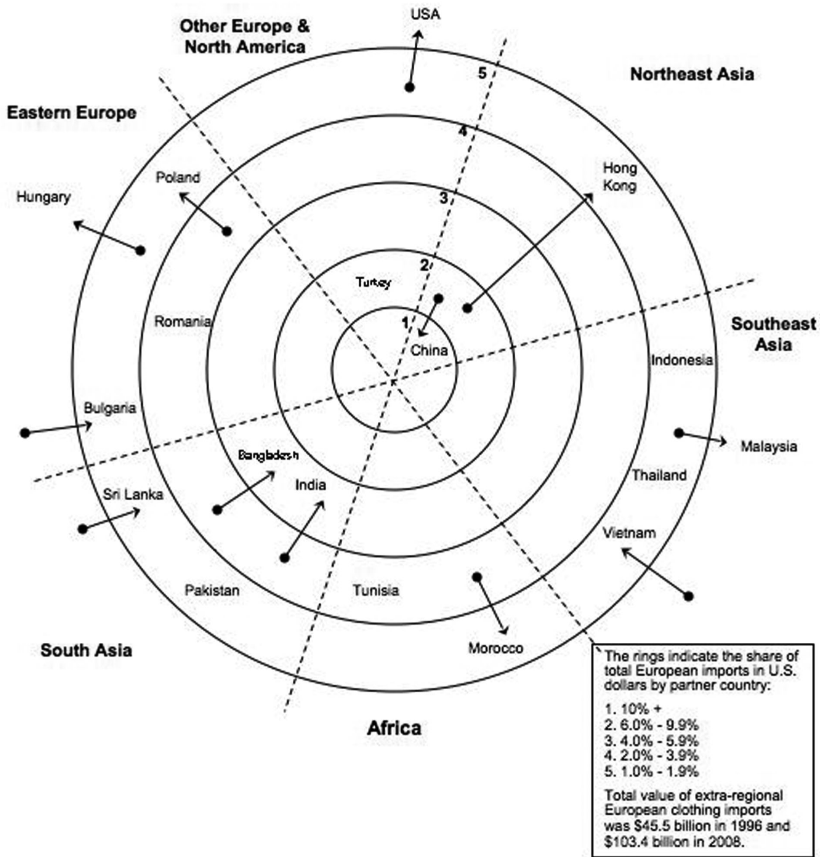
[1]The 2008 position corresponds to the ring where the country's name is located; the 1996 position, if different, is indicated by a small circle. The arrows represent the magnitude and direction of change over time.

N.B.: **From 1996 to 2008, China's import share of the United States apparel market grew from 15.2% to 34.5%.**

Source: Compiled from official statistics of the U.S. Department of Commerce, U.S. imports for consumption, customs value. SITC code: 84 http://dataweb.usitc.gov

Figure A18.1: *Shifts in the Regional Structure of US Apparel Imports, 1996–2008*[1]

Source: USITC (1996, 2008). SITC code 84: US imports for consumption, customs value.



[1] Apparel imports are for the EU-15 countries only. The calculations *include* the value of intra-EU15 trade, but the chart *excludes* the names of the individual EU-15 countries. EU-15: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom.

[2] The 2008 position corresponds to the ring where the country's name is located; the 1996 position, if different, is indicated by a small circle. The arrows represent the magnitude and direction of change over time.

Source: UNComtrade,SITC 84, Rev 3, imports to EU15

Figure A18.2: *Shifts in the Regional Structure of EU-15[1] Apparel Imports, 1996–2008[2]*

Source: UNComtrade (1996, 2008) SITC 84, Rev. 3, imports to the EU15.

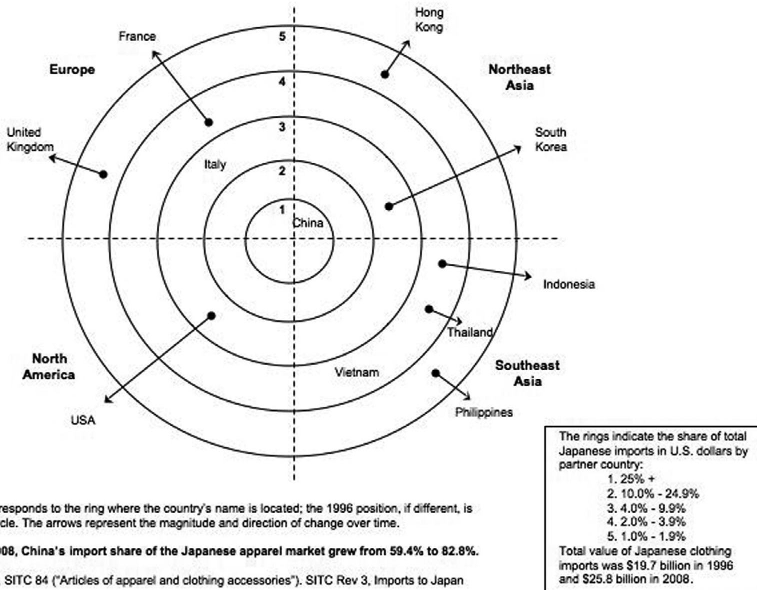


Figure A18.3: *Shifts in the Regional Structure of Japan's Apparel Imports, 1996–2008*[1]

Source: UNComtrade (1996, 2008) SITC 84, Rev. 3, imports to Japan

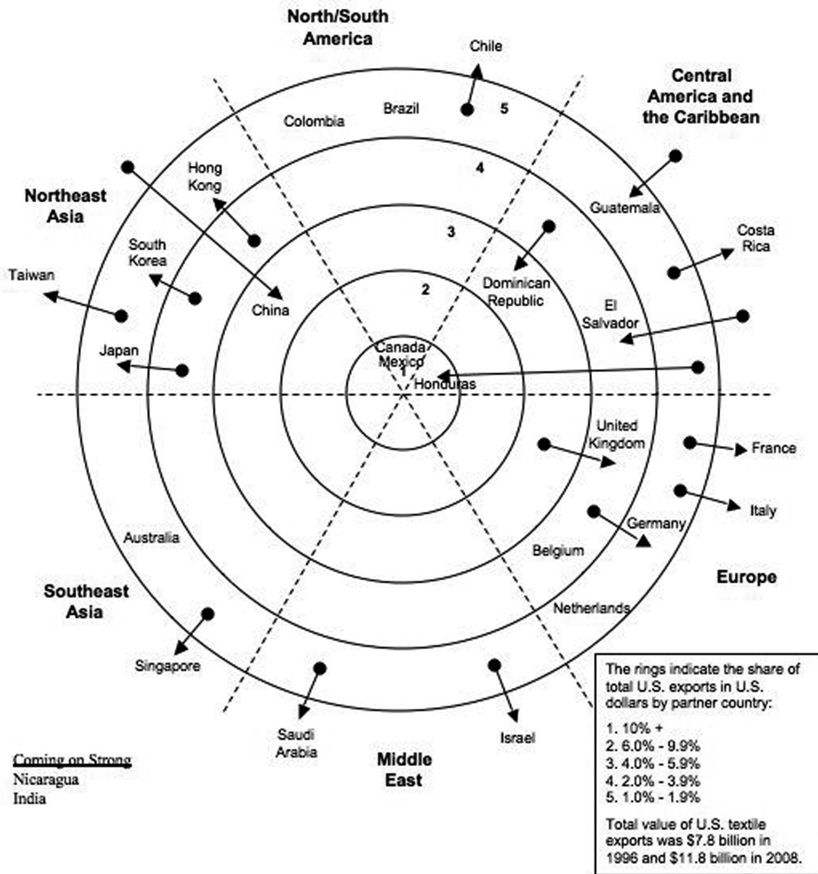


Figure A18.4: *Shifts in the Regional Structure of US Textile Exports, 1996–2008*[1]

Source: USITC (1996, 2008) SITC code: 65, US domestic exports, customs value

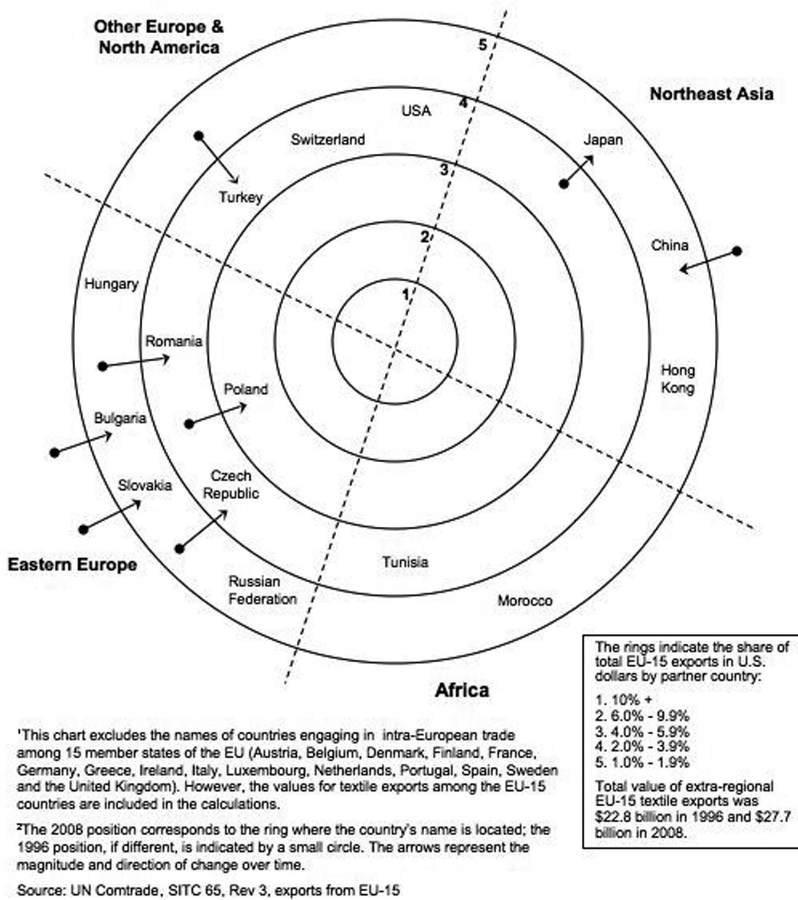


Figure A18.5: *Shifts in the Regional Structure of EU-15[1] Textile Exports, 1996–2008[2]*

Source: UN Comtrade (1996, 2008). SITC 65, Rev 3 exports from the EU15

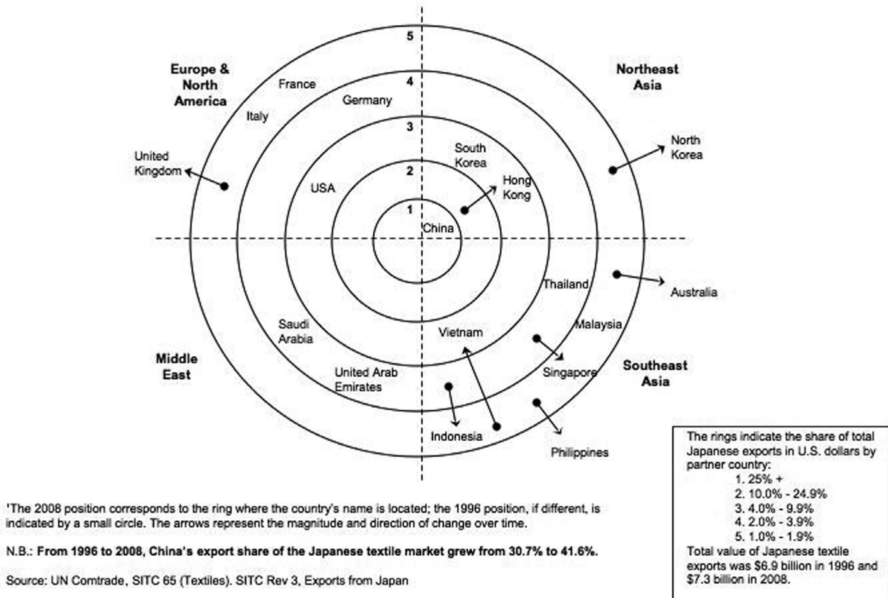


Figure A18.6: *Shifts in the Regional Structure of Japan's Textile Exports, 1996–2008*[1]

Source: UN Comtrade (1996, 2008). SITC 65, Rev 3, exports from Japan.

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19

Is the Crisis Provoking Protection in Services?

INGO BORCHERT AND AADITYA MATTOO

1. INTRODUCTION

The United States accounts for about one-fifth of the imports and exports of services of all OECD countries. For many developing countries, the United States is the most important market by virtue of its size and openness; for example, more than half of India's services exports to the OECD go to the United States. Even more significant than the US share of trade is the power of example it sets. Whether the current crisis is provoking the United States to raise its level of protection is, therefore, an issue of both substantive and symbolic significance.

In this chapter, we first examine (in Section 2) changes in US policy for any sign of explicit protection so far, and we find only a few examples. Each is of limited economic significance, and to some extent is constrained by multilateral or regional trade rules (Section 5). We also identify certain developments that could lead to more subtle forms of protection – notably, increased government ownership of, and conditional financial support to, firms, as well as the growing political and social aversion to 'moving jobs abroad'. These nascent forms of protection could have much more serious economic impact because they affect a much larger share of economic activity and are not meaningfully restrained by international rules.

An examination of recent trends in US services imports in Section 3, however, reveals no sign of adverse policy effects. Even as goods imports have declined, by as much as one-third, imports of private services as a whole, and business services in particular, have continued to grow. Imports of transport, travel, and financial services have declined but that was only to be expected in the current circumstances.

The domestic services sector is, unfortunately, less resilient. We show in Section 4.3 that services employment has not suffered the precipitous declines seen in durable goods and construction (of 12 percent since April 2008), but it too has declined, by around 4 percent. How can we reconcile sustained growth in imports of business, professional, and technical services (by about 7 percent) with significant declines in employment in domestic business and (or) professional services (by about 6 percent)? One possibility is that firms in industrialised countries,

under increased pressure to cut costs during the crisis, are turning to outsourcing.

While growing trade and declining employment can generate pressure to protect, there are other countervailing forces (Section 4). Industrialised countries' firms have made large relationship-specific investments in outsourcing intermediate services; in turn, developing countries have become important markets for industrialised countries' banks, retailers, telecommunications, and transport providers. As a result, the business functions of customers and suppliers of services are highly intertwined. Any protectionist action would be self-defeating, because of its direct costs and because it could provoke retaliatory protection.

2. PROTECTIONISM: EXPLICIT AND IMPLICIT

As in the case of goods, we have not seen significant reversals of policy in services. The commitment of the G20 Joint Declaration of November 15, 2008, to refrain from raising new barriers also covers services, trade, and investment flows. But protection may be beginning to take a subtle form, perhaps in deference to the invisibility of services and the fact that they are increasingly delivered electronically. First, explicit discrimination through preferential procurement seems at this stage less damaging than the implicit social and political disapproval of outsourcing, as well as the growing influence and widening boundaries of the state. Developing countries' service exporters argue that it is the latter that is beginning to introduce an implicit national bias in firms' procurement and location choices. Similarly, the few visible explicit restrictions on employing or contracting foreign services providers in specific areas (for example, financial services) are not as costly for both host and source providers as the increasing social and political aversion to immigration. In the longer term, subsidies to banks are probably less damaging than 'financial nationalism'. The former are temporarily necessary to ensure the stability of the financial system. The latter seriously erode the case for openness. Inducing national banks to lend domestically in a crisis deprives developing countries in particular, of capital when they most need it and greatly strengthens the case for financial self-sufficiency.

Table 19.1 presents examples of restrictions drawn mostly from the United States, which because of its size and openness to trade in services is of greatest significance to services exporters. These measures include, first of all, the observed and explicit: preferential procurement by state entities and firms; restrictions on the employment of foreign nationals; and subsidies to rescue national firms. Then there are measures which have not been observed but may be taken: inducements to lend locally; increased state ownership, conditional subsidies, or political and social pressure inducing firms to buy, locate, and employ nationally.

Table 19.1: *An Illustrative List of Recent and Potential Protectionist Measures in Services*

Measure	Implementation Status (actual / potential)	Impact on Services Trade	Legal Recourse
Preferential procurement by state entities and firms	New 'Buy American' measures (for example in the US fiscal stimulus) do not cover services, though existing preferences may apply to new expenditure.	None (as yet). History of sub-federal legislation to reverse outsourcing shows it was largely inconsequential. And the government share of total domestic demand tends to be small, except in state-level purchases of construction services.	For signatories to the WTO *Government Procurement Agreement* (GPA) or regional GPAs to the extent that both procuring entity and service is covered For non-signatories: none.
Preferential employment requirements for private firms	'*American Recovery and Reinvestment Act of 2009'*: Financial institutions receiving bailout funds face increased restrictions on hiring specialty occupation (H-1B) visa holders. Proposed legislative changes to H-1B (specialty occupation) and L-1 (intracompany transfer) programs (Durbin-Grassley bill). Legislation first introduced 3/29/2007, *'The H-1B and L-1 Visa Fraud and Abuse Prevention Act'* of 2007. Similar legislation *'H-1B and L-1 Visa Reform Act'* of 2009 re-introduced 4/23/2009.	Not significant, since binding constraints are quotas on the total number of specialty occupation visas, but it may hurt foreign professionals with finance-specific skills.	GATS commitments on national treatment on mode 4 (limited in scope)
Subsidies to rescue financial and other services firms	• 237 Capital Purchase Contracts under Capital Purchase Program • 7 Contracts under the Making Home Affordable Program • 1 Contract (Citigroup) under Targeted Investment Program • 1 Contract (AIG, several Series) under Systemically Significant Failing Institutions • 3 Contracts under Automotive Industry Financing Program (as at April 21, 2009)	Significant because it affects structure of financial industry. But temporary(?) interventions may be justified to ensure systemic stability.	GATS commitments on national treatment on mode 3 in financial and other services to give foreign firms the rights to the same treatment
Local lending requirements a) guarantees for local loans b) explicit requirement c) implicit pressure	Some evidence No (UK example: RBS)	Possibly significant impact on access to capital abroad and exports of financial services; but difficult to isolate the impact of inducements to lend locally from other reasons for reversals of capital flows.	None (unless the beneficiaries of directed credit are services firms and any implicit subsidy violates a national treatment commitment under GATS).

Measure	Implementation Status (actual / potential)	Impact on Services Trade	Legal Recourse
Widening state boundaries through acquisition of firms and hence inducing a national bias in firm choices	Increased ownership of troubled firms (for example, '*The American Recovery and Reinvestment Act of 2009*), but there is no sign yet of induced national bias	So far limited (because the government shares of total demand and economic activity are still limited; no obvious change in firm behaviour); but potentially significant if more 'state' firms are obliged to procure preferentially, and to (re-)locate activities domestically.	For signatories to the WTO and GPA, to the extent that both procuring entity and service is covered (unlikely). No recourse for decisions of state firms on where to locate economic activity.
Subsidies to private firms are contingent on national procurement, location, and employment	Rumours of new measures, but no concrete evidence	Potentially significant because a larger share of demand and economic activity would be covered	GATS commitments on market access and national treatment in affected sectors (limited in scope)
Political and social pressure on private firms to procure, locate, and employ nationally	Sallie Mae's relocation of 2,000 jobs back to the United States.	Potentially significant because a larger share of economic activity would be covered	None

2.1 *Preferential procurement*

Regarding explicit protectionist measures, the 'Buy American' provisions in recent US legislation do not extend to services. Yet it is instructive to recall the history of past sub-Federal initiatives that sought to promote onshore employment. For instance in the years 2001-02, New Jersey drafted legislation for preferential procurement, including stipulations that work was to be done by firms with US employees, rather than firms that outsourced. However, the bill was progressively diluted as it passed through the legislative process. To begin with, the Act would only apply to government-funded projects, thereby excluding any private-sector financed projects. Moreover, in the case of a cost differential between potential providers exceeding a certain percentage (approximately 15-20 percent) a waiver would be automatically granted. These modifications rendered the Act ultimately ineffectual, and the New Jersey experience seems to represent the fate of several similar legislative projects in other US states. The apparent popularity of such measures notwithstanding, there appears to be a sizeable US business constituency that would potentially be hurt by such measures, as reflected in a recent letter addressed to President Obama in which 125 companies and a number of business associations caution against the Buy American initiative.

There is also a well-known analytical reason to be relatively sanguine about preferential procurement (Baldwin and Richardson, 1972). If the government switches its purchases towards national suppliers, then the resulting increase in prices of domestic services will induce private consumers to switch their purchases to foreign suppliers. As long as the government's share of the total quantity demanded at the original price is less than the quantity supplied by national suppliers, preferential procurement will have no significant effect.[1] In fact, the US Government

[1] In a recession, if there is excess capacity in the relevant sector, then increased government purchases may not lead to an increase in prices and so there may be no offsetting changes in private demand. Also, if domestic and foreign services are differentiated, or oligopolistically provided, then again we may see real effects of preferential procurement (Mattoo, 1996).

accounts for a relatively small share of domestic demand for most services, except in state-level purchases of construction services (Francois and Nelson, 1997).

2.2 Restrictions on foreign employment

An example of an explicit restriction that does affect services is the provision in the recent US stimulus bill making it difficult for financial institutions that have received taxpayers' funds to hire specialty occupation (H-1B) visa holders if they have recently made US workers redundant. Given the binding aggregate quota on H-1B visas, a restriction on employment in a particular sector probably has limited impact, other than on foreign workers with skills that are specific to the restricted sectors. Thus the restrictions on employing or contracting foreign services providers in specific areas (for example, financial services) are not as costly for both host and source, as the increasing social and political aversion to immigration of service providers and the possibility of retaliatory restrictions. As Lloyd Blankfein, the chief executive of Goldman Sachs warned, the company had 200 people in the United States on H-1B visas but also 2000 employees who worked overseas but who paid US taxes; the latter could be the target of retaliatory measures by other governments.[2]

With regard to securing jobs domestically, the US Administration's recent plan on 'Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas' has occasionally been called 'protectionist'. However, there are no indications that the proposal's measures would affect services trade in a protectionist way (see Appendix 1 for details).

2.3 Changing political and social climate

Turning now to the mounting pressure to support domestic job creation, consider the following example of how firms' choices are being influenced by the change in political mood. On April 6 2009, Sallie Mae, a company which manages $180 billion in education loans and has 10 million student and parent customers, announced plans to move 2000 overseas jobs back to the United States from India and the Philippines, reversing a cost-saving measure the company took a year ago.[3] The company said it plans to fill jobs, including positions in call centres, information technology, and operations, in the United States over the next 18 months. The projected cost is about $35 million annually because of higher labour expenses. The Sallie Mae chief executive Albert L Lord was quoted as saying: "It's the right thing to do. The value of a company's franchise is essentially measured in financial terms, but there are a lot of values in a company that relate to the long-term value of a franchise. It's a wise investment in the company's future…It was a tough decision to move these jobs overseas. It was a lot easier to make the decision to bring them back". Representative Paul E Kanjorski (Democrat from Pennsylvania), whose Wilkes-Barre district will receive 600 new Sallie Mae jobs was quoted as saying:

[2] Goldman Sachs (2009). See also Guerrera (2009).

[3] "SLM to Transfer Overseas Jobs to US: Reston Student Lender to Move 2,000 Workers Out of Asia", by Thomas Heath, *Washington Post*, April 7, 2009.

"It's a patriotic act. It sends a great message to corporate America to think as deeply as you can".

2.4 Widening boundaries of the state

In addition to the changing political climate, a related concern is the widening boundary of the state because of increased government ownership of firms during the crisis. The US Government has already spent $245 billion under the *Capital Purchase Program* (CPP) to hold preferred stocks in more than 200 financial companies. Particularly large investments have been made in the financial giants, Citigroup and Bank of America, under the *Targeted Investment Program* and *Asset Guarantee Program*, and on American International Group, Inc. (AIG) under the *Systemically Significant Failing Institutions Program*. General Motors and Chrysler have received $30 billion under the *Automotive Industry Financing Program and the Automotive Supplier Support Program*. The worry, for which there is not yet a concrete basis, is that state ownership will induce a national bias in firms' choices on the procurement and location of economic activity.

An important determinant of the significance of this potentially protectionist development is the time horizon of public intervention. If government influence on the private sector turns out to be temporary, then there is in principle little cause for concern. Nonetheless, it should be borne in mind that even during a relatively short-lived 'public interregnum' at major private sector companies, long-lasting decisions regarding the location of economic activity could be made that are not easily reversed, even if public influence over corporate decision-making were to wane quickly.

Apart from the widening state influence via ownership in formerly private companies ('extensive margin' of government influence), the crisis is also provoking calls for strengthened prudential regulation ('intensive margin'), that is, rules governing the behaviour of private sector firms. While such regulation is usually *de jure* non-discriminatory, it can tend to have *de facto* protectionist effects. It is too early to judge how far efforts to coordinate re-regulation internationally can ensure that national regulation does not impede international competition.

2.5 Financial protectionism

In the longer term, subsidies to banks are probably less damaging than financial protectionism.[4] The former are temporarily necessary to ensure the stability of the financial system. The latter seriously erode the case for openness. Inducing national banks to lend domestically in a crisis deprives developing countries, in particular, of capital when they most need it and greatly strengthens the case for financial self-sufficiency.[5]

[4] See, for example, Anthony Faiola and Mary Jordan, "British Bank to the World Takes its Cash Back Home: Battered RBS Caught in Protectionist Storm", *Washington Post*, March 28 2009.

[5] In one respect, the crisis has actually resulted in greater openness: the pre-crisis concerns about investments by sovereign wealth funds have been replaced by a craving, at least in the financial sector, for greater capital injections from these entities.

3. WHAT DO TRADE FLOWS TELL US?

There is no sign that services trade is being adversely affected by protection. In fact, we show in a companion paper using the latest trade data from the United States, and more aggregate data from other OECD countries, that services trade is weathering the current crisis much better than goods trade. If there had been protectionist action by the United States against foreign services exporters, then perhaps it would be reflected in import figures. Figure 19.1 shows that in April 2009, the value of US goods imports had declined, year-on-year, by 35 percent and the value of goods exports by 27 percent; in contrast, services imports and exports each had declined by around 10 percent.[6] Within services, not surprisingly, trade in goods-related transport services and crisis-related financial services has shrunk, as has expenditure on tourism abroad. But trade in a range of business, professional, and technical services – which encompass politically sensitive outsourced services – is still increasing, with US exports growing even faster (at 10 percent) than US imports (at 7 percent).[7] Therefore, developing countries like India, which are relatively specialised in business process outsourcing and information technology services, have suffered much smaller declines in total exports to the United States than have countries like Brazil and China and regions like Africa, which are specialised in exports of goods, transport services, or tourism services. We suggest that services trade is buoyant relative to goods trade for three reasons: demand for a range of traded services is less cyclical, services trade and production are less dependent on external finance, and because there has been no serious reversal of openness.

4. THE POLITICAL ECONOMY OF PROTECTION

Given the absence of serious protectionism so far, is there still reason to be concerned? On the political economy of protection, there are two views: the sanguine and the pessimistic.

4.1 'We are ever so intertwined'

One reason for the absence of protectionist measures is the high degree of international integration. Industrialised countries' firms have made large relationship-specific investments in outsourcing intermediate services; developing countries' firms have formed strong links with locally established foreign banks, retailers, telecommunications, and transport providers. As a result, the business functions of both customer and supplier of services are highly intertwined. Any protectionist action would be self-destructive. This mutual dependence situation gives rise to political economy forces that counteract protectionist pressures. A case in point is the open letter, signed by a number of services business associations, in-

[6] Services account for around one-sixth of US imports and over one-fourth of US exports. The Appendix 2 charts present further detail on the share of services sub-categories.

[7] These data pertain to the last quarter of 2008 – the latest period for which data on services subsectors are available.

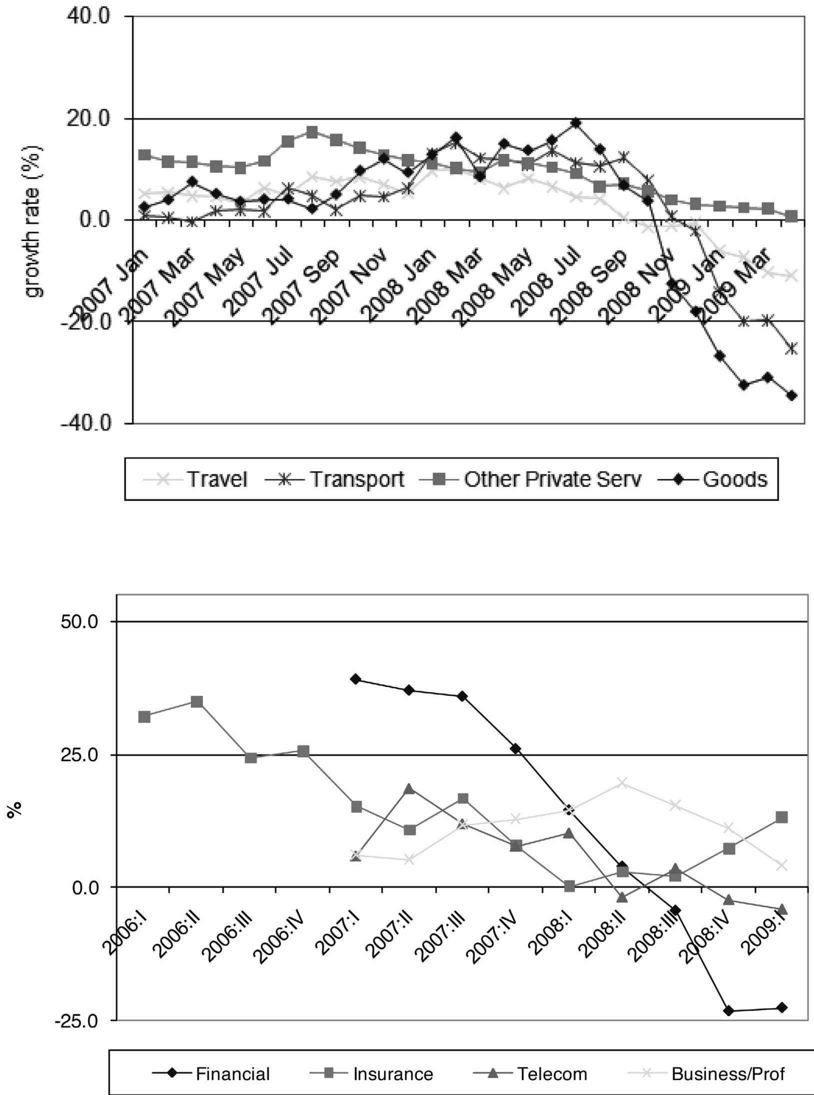

Figure 19.1: *US Monthly Imports of Goods and Subcategories of Services*

Source: Borchert and Mattoo (2010)

cluding the Coalition of Services Industries and the US Chamber of Commerce, to Congressional Leaders on January 22 2009. The undersigned associations note "...the vitally important role that international markets play in sustaining US jobs today and the role they will play in economic recovery. Without sales abroad and access to inputs, many US workers would be out of a job" (USCSI 2009).

4.2 Only some of us are really threatened by trade

Jensen and Kletzer (2008) innovatively use evidence of the geographic concentration of production in the United States as an indicator of tradability. Figure 19.2 below, taken from Jensen and Kletzer (2008, p.9), plots the cumulative distribution of employment in tradeable manufacturing and tradeable business services. It shows that the share of manufacturing employment in industries below the critical $40000 threshold is almost two-thirds (that is, about 60 percent of 13 million workers in manufacturing). In contrast, the share of tradeable business services employment that is in industries with average wages below the $40000 threshold is only about one-third (of about 15 million workers in tradeable business services). Based on these numbers, Jensen and Kletzer suggest that only about one-third of tradeable business services are likely to face competition from low-wage countries in the medium term.

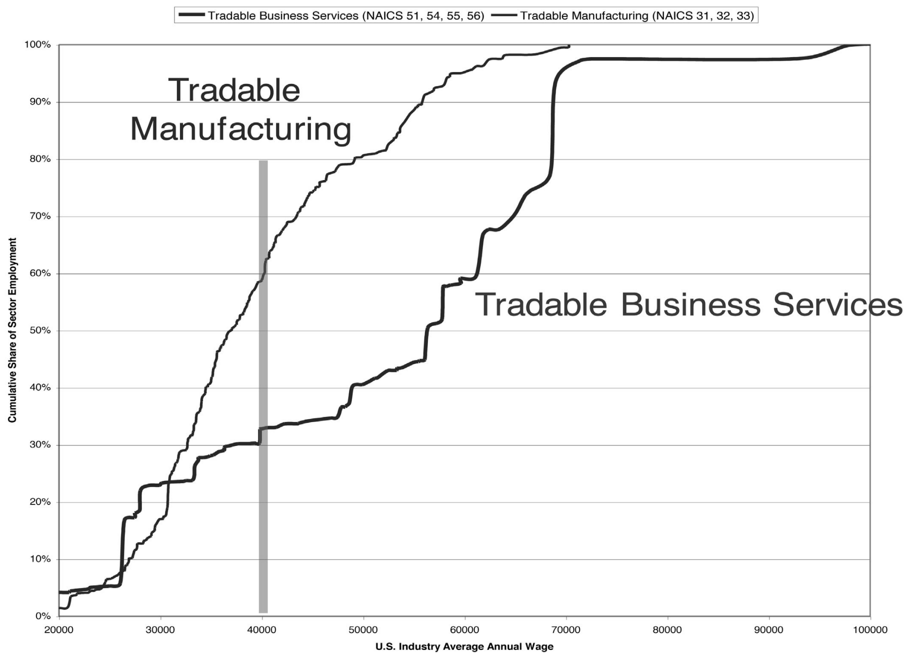

Figure 19.2: *US Employment Shares in Tradable Manufacturing and Services Industries*

Source: Jensen and Kletzer (2008)

4.3 But we are all suffering - Services employment in the United States

Even although most services employment, like services trade, has been relatively resilient in the recession, it has still declined by around 4 percent – while employment in durable goods and construction has declined by over 12 percent since April 2008, see Figure 19.3a below. Within services, employment in education and health services has continued to grow by around 2 percent, but there have been declines of over 4 percent in information services (including telecommunications and audiovisual) and financial services and over 6 percent in transport and business and (or) professional services (Figure 19.3b).

In principle, demand for both imports and domestically produced services should be expected to contract in a recession. How then can we reconcile sustained growth in imports of business, professional, and technical services (see above) with significant declines in employment in domestic business and (or) professional services? One possibility is that firms in industrialised countries, under increased pressure to cut costs during the crisis, are turning to outsourcing. Industry sources in developing countries suggest that in traditional Business Process Outsourcing (BPO) areas, outsourcing options are now being pursued more vigorously, both with captive firms and at arms-length. There has also been a discernable acceleration in the speed with which outsourcing decisions are being taken. While decisions were being taken within 9 to 12 months before the crisis, the decision time has now shrunk to 6 months.[8]

4.4 The restraining effect of the threat of retaliatory protection

The growing political and social aversion to outsourcing in industrial countries is obscuring the economic stake that all countries have in open global services markets. While developing countries like India have seen rapid export growth, by far the largest exporters of these services are the United States and the countries of the European Union. The European Union and the United States account for 65 percent of world services exports; China and India account for 6 percent. The United States and the European Union have both consistently run a huge annual surplus on services trade, currently nearly $160 billion for the United States and $220 billion for the EU countries. While US services imports from India and China have indeed grown to around $22 billion in 2008, US exports to these countries have expanded even faster, to over $26 billion. Even during the crisis US exports of key services are growing faster than its imports.

Both the United States and the European Union have been powerful advocates of open services markets all over the world. Many developing countries have begun to reform their markets for communications, transport, financial, distribution, and other business services. A retreat from openness in services in industrial countries could undermine reform efforts in developing countries, and

[8] Crisis-induced pressure to engage in outsourcing would reinforce the ties of integration mentioned above in Section 4.1. This incentive to outsource would thus generate political economy forces that countervail protectionist pressures.

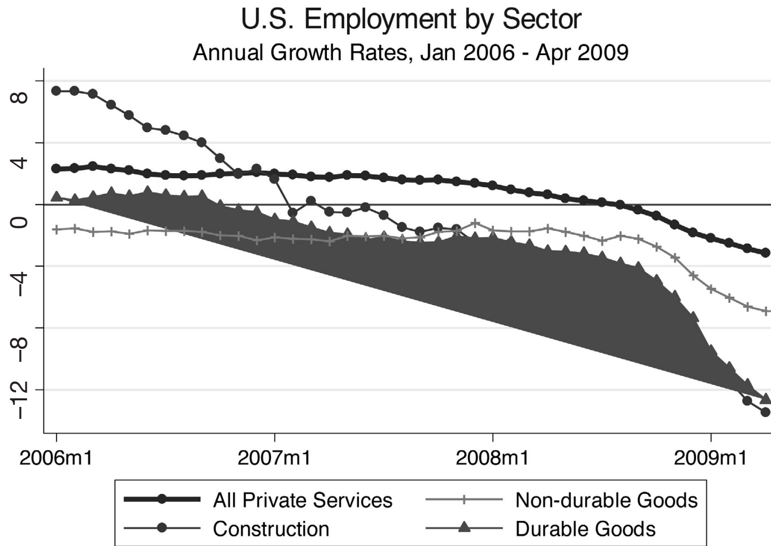

Figure 19.3a: *US Employment in Manufacturing and Services Industries*

Source: Bureau of Labor Statistics (BLS), Current Employment Survey, and authors' calculations.

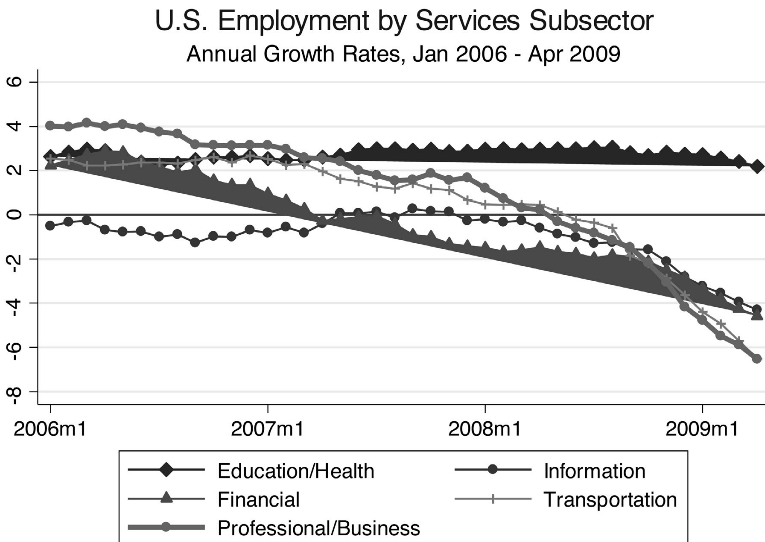

Figure 19.3b: *US Employment in Selected Services Sub-Sectors*

Source: Bureau of Labor Statistics (BLS), Current Employment Survey, and authors' calculations.

even trigger a costly spiral of retaliatory protection. It is conceivable that this threat of retaliatory protection is restraining protection in the industrial countries.

5. MULTILATERAL DISCIPLINES ON PROTECTION: WHITHER DOHA?

How far is protection constrained by existing international rules and commitments?

Gootiiz and Mattoo (2009) survey applied trade policies in the major services sectors of 56 industrial and developing countries. Figure 19.4 compares these policies with these countries' Uruguay Round commitments in services, and the best offers that they have made in the current Doha negotiations. The paper finds that Uruguay Round commitments are on average 2.3 times more restrictive than current policies. The best offers submitted so far as part of the Doha negotiations improve on Uruguay Round commitments by about 13 percent but remain on average 1.9 times more restrictive than actual policies. Figure 19.5 makes the same point from a sectoral point of view, showing that in all major sectors there is substantial scope to limit market access without violating commitments. Hence, current commitments can claim only limited credit for restraining protectionism, even in the United States and industrial countries where the gaps between actual policy and the Uruguay Round commitments are narrower.

In any case, rules and commitments in international agreements only preclude government measures that discriminate against foreign services or service providers (that is, that violate national treatment commitments) or impose quantitative limits on services or service providers (that is, that violate market access commitments) (final column of Table 19.1). Government procurement in services has been excluded from the scope of the WTO *General Agreement on Trade in Services* (GATS) but is to some extent covered by the 'plurilateral' *Agreement on Government Procurement* which has 40, mostly OECD, signatories. Thus, there is today no multilateral rule against discrimination in procurement against developing countries.

More seriously, most rules only apply to 'measures' taken by the government. There is nothing to prevent a state-owned entity from deciding to (re)locate all its economic activities domestically rather than abroad. Also, there is nothing to prevent 'political and social' pressure – which does not take the form of a government 'measure' – from inducing private firms to buy, employ, or locate nationally. Finally, since the GATS has no rules on exports of services, there is also nothing to prevent a government from requiring its banks to lend locally. Hence, a whole range of implicit protectionism that does not take the form of 'measures affecting imports' is currently beyond the scope of multilateral rules.

6. LOOKING AHEAD

Even although there has so far been limited recourse to protectionism in services, it would be wrong to be complacent. We suggest, first of all, greater efforts to

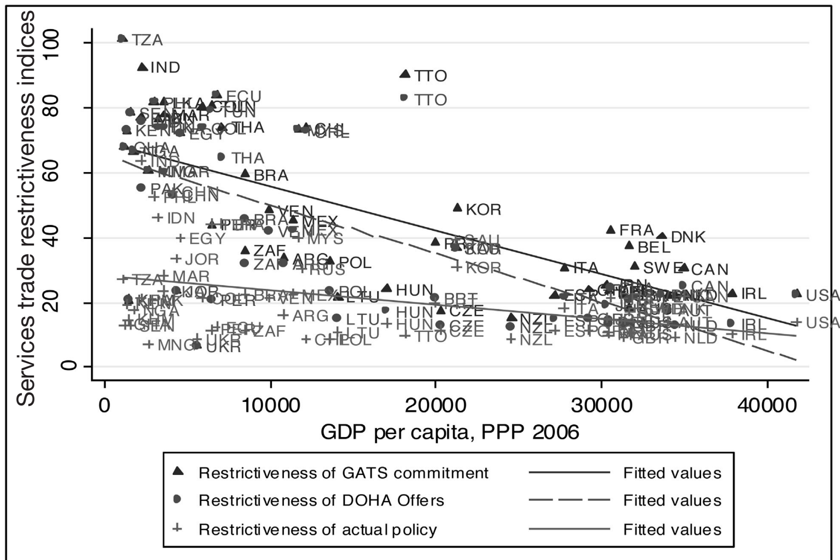

Figure 19.4: *Global Services Trade Restrictiveness, by Country*

Source: Gootiiz and Mattoo (2009)

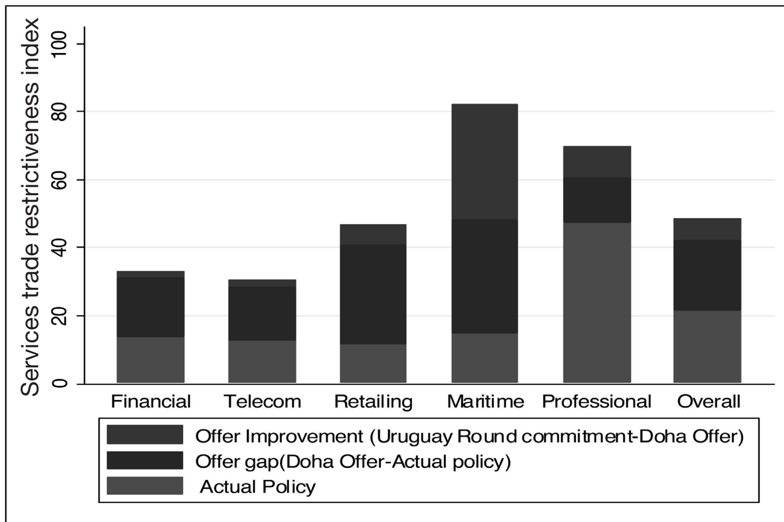

Figure 19.5: *Global Services Trade Restrictiveness, by Sector*

Source: Gootiiz and Mattoo (2009)

monitor protectionist actions in services – which have so far largely escaped WTO scrutiny (with the exception of financial bailouts). Second, the Doha negotiations must aim to lock in existing policies in at least the major trading countries. Third, there is need for greater discussion on how to address the possible home-market bias created by widening boundaries and the increasing influence of the state.

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APPENDIX 1: THE OBAMA ADMINISTRATION'S PROPOSAL FOR 'CURBING TAX HAVENS AND REMOVING TAX INCENTIVES FOR SHIFTING JOBS OVERSEAS'

Certain sources have called the Obama plan 'protectionism' (for example, the Heritage Foundation). In this appendix we briefly summarise the Obama Administration's proposal and show that it does not entail any measures that would have an impact in a protectionist way on services trade or outsourcing. The Obama Administration's plan, advanced on May 4 2009, entails three changes:

First, a reform of deferral rules: US taxes on profits earned abroad by US-headquartered companies are usually not due until those profits are brought back to the United States. Nonetheless, expenses supporting those overseas investments can be deducted immediately to lower US tax liabilities. The proposal would simply bring into synchronisation the levying on taxes and the tax deductibility of expenses, such that deductions cannot be claimed until taxes have been paid on offshore profits. Thus, the proposal would harmonise the rules for tax benefits for investing domestically and abroad, yet the existence of the deferral system, as such, means that the proposal would still not fully neutralise the incentives, because deferral is not an option for domestic investment.

Second, a reform of rules on foreign subsidiaries: so-called 'check the box' rules have allowed US parent companies to make their foreign subsidiaries 'disappear' for tax purposes. Income shifted between any overseas subsidiaries has to be reported as passive income by the US parent company and is subject to US taxation. By checking out those subsidiaries, the ensuing taxes due in the United States disappear as well. The proposal would require foreign subsidiaries to be considered as separate legal entities for US tax purposes. The current legal situation (pre-reform) is a device for shifting income from one overseas investment (the productive one) to a so-called tax haven. Since under current law only offshore subsidiaries may 'disappear' (but not US subsidiaries), this indeed creates an advantage for investing overseas compared with producing domestically. The proposal would remove discrimination against US non-multinational companies (in 2004 the effective tax rate for multinational companies was 2.3 percent, compared to a statutory 35 percent). Clint Stretch of Deloitte estimates that the tax burden would increase by 8 percent but much more for multinational companies. After all, nearly one-third of all profits reported in 2003 by US companies came from just three small countries: Bermuda, the Netherlands, and Ireland.

Third, a reform of rules to claim tax credits for taxes paid overseas against taxes due in the United States: usually foreign tax credits are only available for taxes paid on income that is taxable in the United States, however certain rules make it possible to claim tax credits for taxes paid on foreign income that is not subject to current US taxation. Abandoning this rule would primarily eliminate an advantage that US multinationals previously enjoyed over US domestic companies.

It is also worth pointing out that the proposal outlined above does not call for an end to the deferral scheme as such. Specifically, to the extent that deferral of both deductions and taxes confers a net benefit as compared to paying taxes net of deductions immediately, the playing field is not yet level between domestic and international investment decisions. Moreover, the plan does not propose any changes regarding rules on transfer pricing, which is believed to be the most

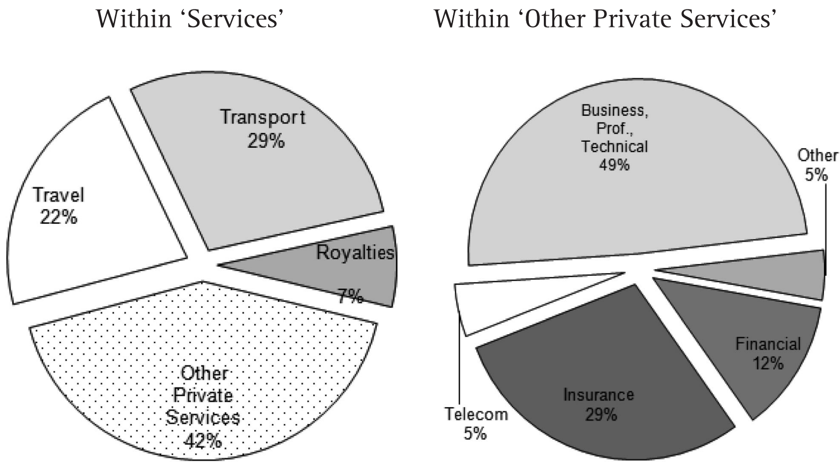
widely used tactic for multinational companies to reduce taxes they owe to the United States.

It is true to some extent that the plan would disadvantage US multinationals that compete with multinationals from other jurisdictions, as most countries have a territorial tax system which subjects only profits realised within its territory to taxes, whereas the United States is part of a dwindling minority of industrialised countries that, in principle, tax corporate profits on a global basis, which in turn necessitates double-taxation agreements and deferral rules. If other tax systems offer more lenient treatment to multinationals, then there is an incentive to locate headquarters outside the United States. The plan takes a step towards neutralising the incentives to invest abroad and at home; but the effect on employment in the United States is unclear.

APPENDIX 2: THE COMPOSITION OF US SERVICES TRADE

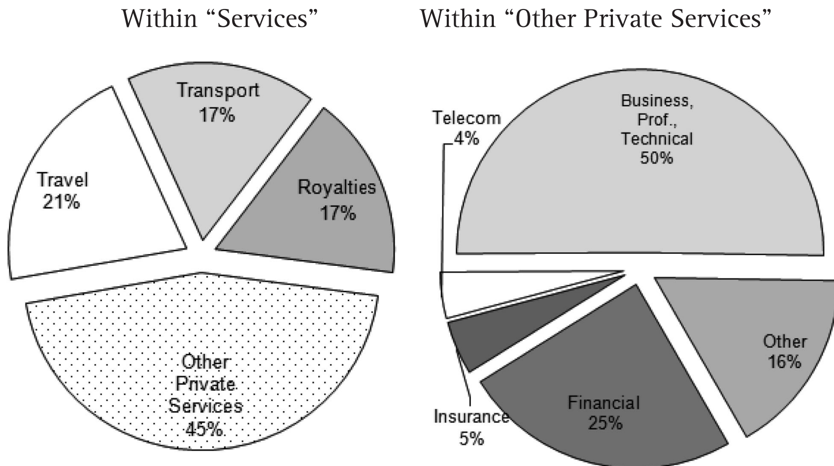
Imports 2008

Within 'Services' Within 'Other Private Services'



Exports 2008

Within "Services" Within "Other Private Services"



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