



## Back to the bad old days?

### The return of protectionism

June 4, 2009

**The WTO and the World Bank report a rapid increase in protectionist measures since the beginning of the economic crisis.** The World Bank has registered 89 new restrictions on trade since October 2008, 23 since the London G20 summit in early April alone, and the WTO an even greater number still. Protectionist measures have increased particularly since the spillover of the crisis to the real economy. Protectionism is more topical than ever.

**There is still a lobby for protectionist measures.** In times of slumping national and international demand, countries and companies will continue to favour beggar-thy-neighbour measures which will (unjustifiably) make their products more competitive than those of foreign rivals or else shield them from competition from the outset.

**Tariff hikes account for “only” about one-third of the measures recorded world-wide – protectionism has many faces:** non-tariff barriers to trade and the abuse of anti-dumping measures, subsidisation of national industries or, very lately, calls to favour domestic products and companies in national economic stimulus packages, and restrictions on international capital flows or immigration.

**The competition and trade-distorting effects of subsidies pose the biggest risk.** In times of strong intra-industry trade the focus of protectionism is shifting away from discriminating against foreign competitors by imposing tariffs towards actively providing preferential treatment to domestic firms via financial aid. The global automobile industry is a case in point. Retaliatory measures are the response.

**These factors threaten to unleash a spiral of protectionism that perhaps may not choke off the global recovery, but it will partly delay its progress.** As regards monetary and fiscal policy, the authorities have learnt the right lessons from the Great Depression. What this means here is that policymakers must not sacrifice medium-term growth opportunities for near-term protection interests. Shoring up open markets and free trade is the next major challenge in a globally coordinated drive to cope with the crisis.

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#### Developing countries protect their firms from (subsidised) competitors from abroad

Number of anti-dumping investigations



Source: World Bank Global Antidumping Database

## Introduction

In times of financial and economic crisis protectionist tendencies threaten to exacerbate the slump in world trade. The expansion of trade volumes worldwide contracted to 3% by September 2008, and was thus down by roughly one-third on the year-earlier reading. As a matter of fact, world trade is set to fall by as much as 15% in 2009 – the first decline since 1982.<sup>1</sup> This is compounded by tendencies to close off markets at the national level, threatening to inflame the situation particularly since the spillover of the crisis to the real economy. For Germany as a nation whose exports account for 48% of GDP, the trend is particularly devastating. Among the automakers, in fact, the export share comes to no less than 75%.

The yardstick is clear as it crops up time and again in the media: the Great Depression of 1929-1933. During this period, the volume of world trade shrank by close to two-thirds, and the closing-off of national markets turned a recession into a full-fledged depression. The heads of state and government of the G20 are currently pledging their commitment to ensure open markets and they seem to be learning the lessons taught by the Great Depression. Nevertheless, the World Bank says these countries have launched 89 measures limiting world trade since October 2008 – with 23 of the measures introduced since the latest commitment to free trade at the London G20 summit in early April.<sup>2</sup> The World Trade Organization (WTO) also reports a multitude of new trade restrictions which we will look at in greater detail.<sup>3</sup> There are compelling reasons for a comparison with the 1930s.

### Protectionism has many faces

The objective of this study is to show what guise protectionism assumed in the Great Depression and, on this basis, to point out which forms are appearing in the current crisis. In so doing, we intend to assess the risk of today's protectionist measures exacerbating the crisis in the way protectionism did back then.

## 1. Protectionism during the Great Depression of 1929-1933

### Tariff hikes, ...

During the Great Depression, the Smoot-Hawley Tariff Act of 1930 triggered the worsening of the recession via protectionist trade policy. Smoot-Hawley was responsible for boosting the import duties on over 900 goods in the US, with the average rate rising from some 25% to 50%. The objective of this policy was to protect domestic producers from foreign competition and thus cushion the impact of the crisis on US companies. However, this competitive advantage only lasted as long as it took for the other countries to follow suit. And they wasted no time: by 1931, for example, the average import tariff in France had risen to 38%, and in Germany to 41%.

### ... restrictive fiscal and monetary policies as well as ...

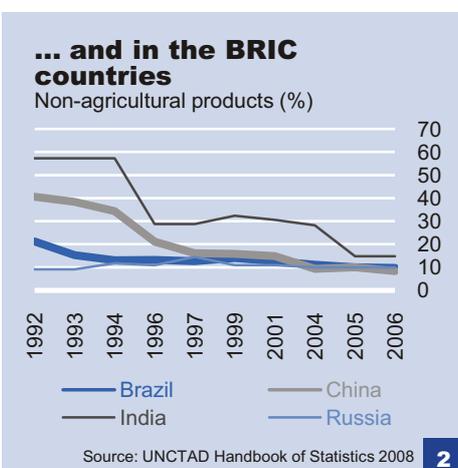
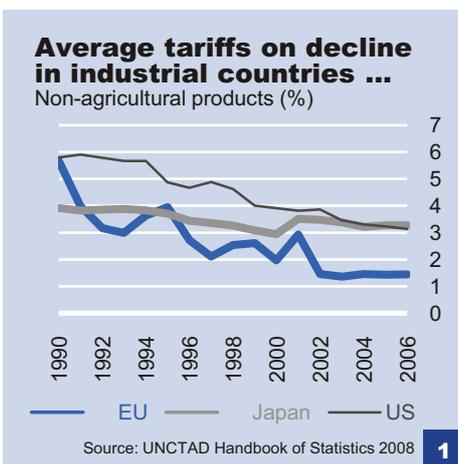
As a consequence of the trade war, the strongly integrated economies had to cope not only with the ongoing economic downturn but also with huge export losses stemming from the introduction of national protectionist measures. Logically, they then had to rely more strongly on domestic demand. However, little scope remained for stimulus programmes to boost domestic demand

<sup>1</sup> United Nations (2009). World Economic Situation and Prospects 2009. New York and OECD (2009). OECD Economic Outlook Interim Report.

<sup>2</sup> Gamberoni, E. & R. Newfarmer. (2009). Trade Protection: Incipient but Worrisome Trends. Trade Notes World Bank; WTO (2009). Fact Sheet: G20 Countries: Actions on Trade since April 2, 2009.

<sup>3</sup> WTO (2009). Report to the TPRB from the director-general on the financial and economic crisis and trade-related developments (JOB(09)/2 and JOB(09)/30).

### ... currency devaluations significantly exacerbated the crisis in the 1930s



because the nations pursued a restrictive fiscal policy in line with the then conventional economic wisdom urging governments to maintain a balanced budget.

Besides, tight monetary policy was also the order of the day until the mid-1930s, the aim being to rein in speculative stock-market trading as it was presumed to have partly caused the crisis. However, this only resulted in the rest of the economy sliding into a severe credit crunch. In Germany's banking crisis of 1931, the central bank raised its key rates significantly and thus exacerbated the liquidity crisis of the banks. Combined with restrictive fiscal and monetary policies the protectionist measures led to a huge slump in corporate demand both at home and abroad.

To keep demand for exports from collapsing altogether, the countries also launched a round of competitive devaluation. They hoped that by actively weakening their own currency they would make domestic companies more competitive on the world market. The United Kingdom, the birthplace of free trade, abandoned the gold standard in 1931 and devalued the pound by 30%. The US followed suit in 1933 and France in 1936, further distorting trade competition.

The worsening of the economic crisis via the above-mentioned protectionist measures shows the risks of a similar trend in the current situation. This holds all the more since the crisis back then, much like today, came on the heels of an era of trade liberalisation and strong international integration of national economies. Equally, according to studies of economic history, the evolution of the crisis to date is indeed comparable with what was seen in the Great Depression: first came the stock-market crash in 1929, the banking crisis in 1931, the flight from world commerce and, finally, the Depression.<sup>4</sup> A flight from world commerce is still not clearly visible, although the risk unquestionably exists. Therefore, in the following we shall discuss the current protectionist tendencies and examine the extent to which they may lead to a worsening of the crisis the way protectionism did back then.

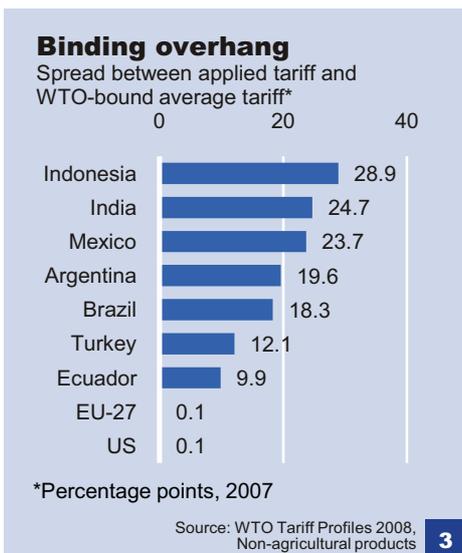
## 2. Protectionist tendencies in the current economic crisis

### 2.1 Increase in tariffs

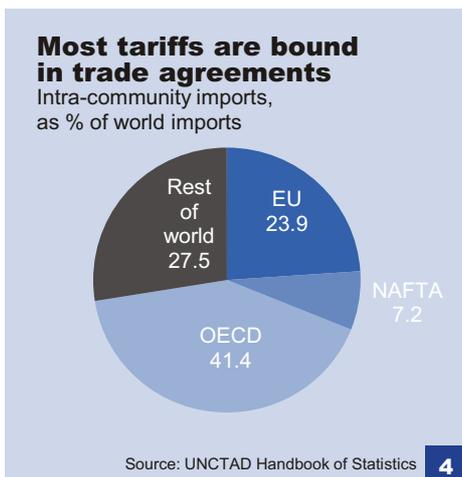
According to the United Nations Conference on Trade and Development (UNCTAD), before the onset of the current financial and economic crisis tariffs fell steadily from 1990 to 2006 both in the developed economies of the EU, the US and Japan as well as in the emerging markets of Brazil, Russia, India and China.

In response to the crisis, though, some countries are planning to raise their tariffs or have already done so. Since November 2008, Russia has boosted its import duties for a temporary period of 9 months: to 15-20% on iron and steel products, 30% on cars and 25% on trucks and buses. In Turkey, too, import duties have increased on various iron products since the end of last year, from around 5% then to 15% now. At the beginning of 2009, India reinstated the former tariff rate of 5% for a series of iron and steel products and imposed a 20% tariff on imports of soybeans. It has completely banned Chinese toys from the market, unless they meet stringent health and safety standards. Argentina and Brazil are

<sup>4</sup> Werner Abelshausen quoted from Hoffmann, C. (2009). Wirtschaftskrisen im Vergleich: Auftakt zur Depression. Süddeutsche Zeitung.



**Tariff hikes also possible today ...**



**... but less attractive**

attempting to raise the external tariffs on wine, leather, dairy products, wood furniture and textiles for the entire Mercosur region (Common Market of the South). And Ecuador has increased the tariffs on 940 of its import products by 5-20 percentage points in order to, according to officials, narrow the deficit on its balance of payments.<sup>5</sup>

Such tariff hikes are possible below the justifiable level because there is a “binding overhang”: over the past few years, the emerging markets in particular have unilaterally lowered the tariffs they impose below the level allowed in the WTO since the Uruguay Round. In 2007, the duty for non-agricultural products in Brazil, for example, was 12.5% (maximum allowed: 30.8%), in India 11.5% (36.2%) and Indonesia 6.7% (35.6%). These countries could easily hike their tariffs as retaliatory measures for protectionist steps in the industrial countries – especially by keeping high tariffs on strategic products in spite of a decline in the average rate. The binding tariffs would only be fixed at a lower level if the Doha Round were concluded.

In addition, the growing market share of the emerging markets, which continue to charge high tariffs, means a larger share of world trade would again be affected by such restrictions. While the crisis cannot be blamed for this trend, it may very likely delay the further reduction of tariffs in the emerging markets.

Nevertheless, tariff hikes currently represent a much smaller risk than they did during the crisis of 1929-1933 when they were the conventional channel of protectionism. A trade war of similar proportions is unlikely to ensue today since close to 75% of global trade takes place either within customs unions or free trade areas, such as the EU and NAFTA, or between OECD countries. In the former, tariff restrictions have been lifted completely, while in the latter they are at the level set by the WTO. In both cases, violations can be sanctioned effectively.<sup>6</sup>

For instance, “only” about one-third of the trade-restricting measures introduced since October 2008 have been tariff hikes, though the share in the emerging markets has been no less than 50%.<sup>7</sup> If the Doha Round were brought to a rapid conclusion this would further reduce the risk; however, this appears to be extremely difficult considering the current global recession.<sup>8</sup>

Moreover, there is a significant decrease in lobbying for tariff increases in times of widespread intra-industry trade. Domestic exporters who import their factor inputs are hit just as hard by tariff hikes as foreign exporters. Therefore, they are scarcely likely to urge their governments to boost their tariffs.

**2.2 Non-tariff barriers to trade**

Since international agreements limit the scope for countries to hike their tariffs, protectionist measures are increasingly assuming the shape of non-tariff barriers to trade. These are not financial levies, but they have a similar impact.

<sup>5</sup> WTO (2009). Report to the TPRB from the director-general on the financial and economic crisis and trade-related developments (JOB(09)/30).

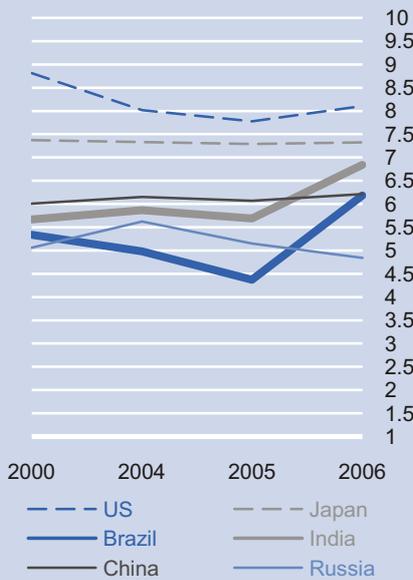
<sup>6</sup> Francois, J. (2009). The economic crisis, Doha completion, and protectionist pressure. VoxEU.

<sup>7</sup> Gamberoni, E. & R. Newfarmer. (2009). loc. cit.

<sup>8</sup> Langhorst, Ch. and S. Mildner (2009). Finanzkrise und Welthandel: Der Abschluss der Doha-Runde könnte einen wichtigen Impuls geben. Stiftung Wissenschaft und Politik. Berlin.

### Still more or less stable before the crisis

Regulatory trade barriers, 10 = no barriers

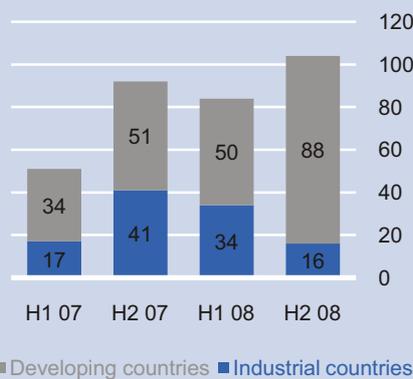


Source: Fraser Institute: Economic Freedom of the World 2008 Annual Report

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### Developing countries lead on investigations

Number of anti-dumping investigations

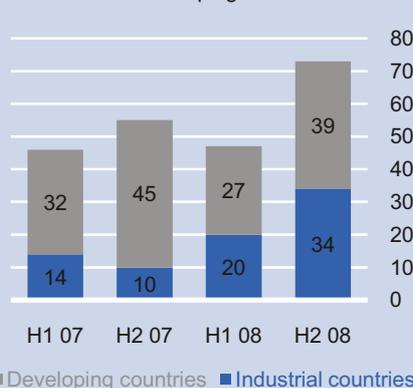


Source: World Bank Global Antidumping Database

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### Industrial countries resort to more measures

Number of anti-dumping measures



Source: World Bank Global Antidumping Database

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According to the Economic Freedom of the World 2008 Annual Report, the regulatory trade restrictions in place in the pre-crisis period 2000 to 2006 were of a largely stable nature. European exporters lost a total of EUR 21.4 bn in China alone though in 2004 because of non-tariff barriers to trade. European firms now regard non-tariff trade barriers as a bigger obstacle than tariffs.<sup>9</sup>

Among non-tariff barriers to trade, one needs to differentiate between **direct** and **indirect** barriers. Direct non-tariff trade barriers serve the purpose of strategically and systematically protecting domestic producers. They include complex customs clearing procedures, the abuse of anti-dumping measures, discriminatory tax and certification requirements, discriminatory public procurement systems and subsidies for certain branches of industry.

Indirect barriers, by contrast, arise from differences in national regulatory practices and differing policy objectives. These include diversity of technical, environmental, social and consumer-protection standards, sanitary and phytosanitary regulations (SPS), and differing levels of protection and enforceability in respect of intellectual property rights (IPR).

In the current crisis, countries have launched protectionist measures of both kinds. In terms of **direct barriers**, for example, import procedures have been tightened: Indonesia for one has decided to limit the import route for over 500 different goods to six ports and the international airports, including electronics, toys, food, shoes and clothing. This is said to be in the interest of health protection and safety.

The number of anti-dumping investigations initiated also jumped in 2008 compared to 2007, by 31% (from 143 to 188). In tandem with the emerging crisis in the second half of 2008 their number rose by 24% versus the first half of the year (from 84 to 104). This increase is solely attributable to the developing countries (up 76%, from 50 to 88) since the number of investigations in the developed countries actually fell during that same period (by 53%, from 34 to 16). India was particularly active in this respect, launching 40% of the total measures initiated (42 of 104) in the second half of 2008, followed by Brazil with 15% (16 of 104).

Since the onset of the crisis, the number of anti-dumping measures actually implemented has increased even more noticeably (up 55%, from 47 to 73) than the number of investigations announced. Anti-dumping measures have climbed in both the developed countries and the developing countries; the former were more active in fact (up 70%, from 20 to 34) than the latter (up 44%, from 27 to 39).<sup>10</sup> Some 19 of the 23 newly recorded trade restrictions since the London G20 summit in early April 2009 are linked with the use of anti-dumping instruments.<sup>11</sup>

The rapid increase in anti-dumping investigations and anti-dumping measures since the beginning of the crisis may be interpreted in two ways: on the one hand, the WTO Anti-Dumping Agreement provides for anti-dumping investigations and possibly also anti-dumping measures in case a foreign company sells its products cheaper on one export market than at home or on another export market (dumping) and there is thus a negative impact on the domestic

<sup>9</sup> European Commission. COM(2008) 874 and COM(2008) 774. Brussels.

<sup>10</sup> World Bank. Global Antidumping Database; Brown, C. (2009). Monitoring Update to the Global Antidumping Database.

<sup>11</sup> WTO (2009). Fact Sheet: G20 Countries: Actions on Trade since April 2, 2009.

### Rapid increase in anti-dumping investigations and measures suggest a greater amount of trade distortions

industry of the export target country. It follows that the instruments serve to protect a country from trade distortions caused by a trading partner. A company might be able to offer lower prices abroad because it receives an export subsidy from its home country, for instance. In such cases, the WTO does make exceptions and allows punitive tariffs as countermeasures. On the other hand, a country may misuse these instruments in order to protect domestic industry from foreign competition even if there is no record of a foreign rival actually dumping products on the market. This gives rise to a direct non-tariff trade barrier by the country using the anti-dumping instruments.

It is difficult to say which of the two possibilities is responsible for the rapid increase in anti-dumping investigations and anti-dumping measures since the crisis started. Generally, though, it is worrying because it shows an overall increase in trade distortions either by the trade partner (example: export subsidies) or by the country which uses these instruments improperly. These developments thus confirm the hypothesis that in times of slumping demand countries will continue to seize "beggar-thy-neighbour" measures which favour their own companies over foreign competitors or shield them from the others.

#### **Subsidy race**

Further direct non-tariff trade barriers include subsidies for domestic producers in the framework of national industrial policies. In times of collapsing demand many countries resort to this instrument to increase the competitiveness of their own companies. People often still underestimate the fact that subsidies for domestic industries can pack roughly the same punch as import tariffs do. There is a risk of a subsidy race erupting between industrial countries and emerging markets in which the latter can only lose on account of their often overstrained budgets.<sup>12</sup>

### Subsidies in the automobile sector ...

At present, the industrial countries have earmarked support measures totalling USD 43 bn for the **automobile industry**. Some USD 17.4 bn of this total came from the US government and was transferred to two of America's "Big Three". The US government linked the aid to certain conditions being met; however, the carmakers had not satisfied these conditions by the deadline of end-March 2009. The deadline was simply extended. Thus, the jury is still out. However, the prospect of further competition-distorting aid being granted cannot be ruled out.<sup>13</sup>

For fear of their own economies being put at a disadvantage, other countries have already followed suit: direct neighbour Canada offered credit totalling USD 4 bn to US automakers' plants on its soil. Sweden is giving its auto industry a shot in the arm with loans and credit guarantees totalling around USD 3 bn (SEK 25 bn). Japan is offering loans equivalent to USD 5.1 bn to its automakers with foreign operations. France is granting USD 6 bn in aid to French carmakers, and Brazil is stepping in with USD 1.7 bn for its industry. The United Kingdom is also promoting the automotive sector with incentives worth USD 3.3 bn for developing "green technologies".<sup>14</sup>

<sup>12</sup> Langhammer, Rolf (2009). „Unfairer Wettbewerb“. Handelsblatt, March 17, 2009.

<sup>13</sup> For more on this issue see <http://www.whitehouse.gov/blog/09/03/30/GM-and-Chrysler/>. As of April 15, 2009.

<sup>14</sup> WTO (2009). Report to the TPRB from the director-general on the financial and economic crisis and trade-related developments (JOB(09)/2 and JOB(09)/30).

**... lead to trade distortions and protect excess capacities**

Advocates of such aid argue that as long as all countries support the auto industry and do not confine their aid to national producers, competition would hardly be distorted at all. Besides, they say that saving jobs is more important. Government presumably has no choice during the current crisis but to prop up the economy; however, support measures for sectors and suppliers considered “systemically important” will always be tantamount to preferential treatment for them vis-à-vis competitors from abroad. Distortions arise because aid comes in different shapes and sizes and some countries can only offer minor aid or perhaps no support at all. Moreover, excess capacities are protected while market exits and adjustment processes are obstructed or delayed.

A perhaps less protectionist approach to aid would be to boost private consumption instead of directly supporting the producer side. Some countries actually are pursuing such a policy: Germany offers consumption incentives in the form of its “environment (=scrapping) bonus” for cars, with the total now coming to EUR 5 bn (boosted from EUR 1.5 bn originally). China, Brazil as well as South Korea have temporarily reduced sales tax on automobiles. This favours both domestic and foreign producers, and competition to offer the customer the best deal is less strongly distorted. Furthermore it compels companies to keep their products competitive, which makes the companies themselves more competitive over the long term. However, such measures have a much smaller scope than direct subsidies and therefore it is debatable to what extent they can actually satisfy the political motivation of averting a market exit.<sup>15</sup>

**Farm subsidies ...**

Besides the automotive sector, subsidies can mainly be found in the **agricultural sector**. In this sector, in fact, subsidies sometimes kick in automatically if prices of farm products fall below a prescribed level. The World Bank estimates that agricultural subsidies will climb by USD 1.8 bn in the United States in 2009, to USD 9.9 bn. The EU re-introduced export refunds for butter, cheese, and whole and skimmed-milk powder in January.<sup>16</sup> This is a particularly sticky problem because the stalled Doha Round is aiming for an extensive reduction of such farm subsidies.

The emerging markets of China, Brazil and Argentina are attempting to stem the tide with subsidies of their own totalling approximately USD 5 bn, besides increasingly introducing anti-dumping investigations as discussed above. China and India are providing more assistance to their exporters with reimbursements for export duties. The emerging markets are fighting a hopeless battle, though, since their budget situation does not allow them to offer comparable aid. This is why they are increasingly resorting to import tariffs in their defence. The industry subsidies in the developed countries prevent the emerging markets from overcoming their dependence on commodity exports and being able to diversify their economies into attractive locations for industry.

**... prevent the diversification of the economy in emerging markets****"Green protectionism" ...*****Environmental regulations***

With **indirect trade barriers**, tightened environmental safety rules top the list (the slogan is: “green protectionism”). Worldwide efforts on climate protection harbour potential for protectionist measures. For instance, the EU plans sustainability criteria for bio-fuel in the

<sup>15</sup> Moreover, sector-specific consumer incentives are always made at the expense of other domestic industries, so the use of state funds has to be examined carefully to ascertain its economic impact.

<sup>16</sup> Gamberoni, Elisa and Richard Newfarmer (2009). loc. cit. WTO (2009). JOB(09)/30.

framework of its directive on renewable energy sources – the share of bio-fuels is thus set to increase to 10% of fuel consumption by 2020. Some countries have already taken issue with such plans: Brazil, for example, fears that EU producers will enjoy preferential treatment in their member states. Moreover, debate is continually being sparked within the EU over the introduction of climate tariffs as trade sanctions against polluters. The idea is that special duties are levied on imports from countries with lower environmental standards.<sup>17</sup> Similarly, some national crisis programmes in the industrial countries contain environmental safety measures with a protectionist hue. For example, the US package promotes the manufacture of environmentally-friendly advanced battery systems and similar components with loans totalling USD 2 bn, but only for manufacturers within the US.

**... is the wrong answer to the global problem of climate change**

Such short-sighted, unilateral environmental safety measures with protectionist tendencies could have far-reaching long-term consequences: climate change is a global problem and requires global responses. The cooperation of the rapidly growing emerging markets in particular is essential. However, if the latter fear that the advanced countries may misuse the climate change issue to support domestic producers and this ends up hurting the economic development of the emerging markets, there is a risk of their not agreeing to a globally coordinated approach to environmental protection when they convene for the climate summit in Copenhagen in late 2009. This could have unforeseeable repercussions and entail significantly higher costs than the benefits of short-sighted, national protectionist measures.

**Tariff race in the 1930s – subsidy race today?**

Among the above-mentioned direct and indirect non-tariff barriers, no doubt the greatest danger lurks in the trade-impairing effects triggered by national subsidies – if for no other reason than the scale to which such subsidies are being planned or have already been implemented. This suggests that the subsidy race of today could assume the role of the tariff race during the Great Depression which severely exacerbated the slump in world trade.

**2.3 Currency devaluations**

A further form of protectionism is discretionary currency devaluations, which can escalate into competitive devaluations between countries. By actively weakening their own currency against foreign currencies, countries make their exports cheaper and thereby domestic companies more competitive in the world market. At the same time, the goods imported from abroad increase in price.

**Exchange rate distortions?**

The problems of politically distorted exchange rates have been a subject of debate for a long time. In its latest report, the US Treasury upholds its assertion that China's sizeable current-account surplus and huge foreign-exchange reserves suggest that the renminbi is undervalued even though the Chinese currency has appreciated by 21% since mid-2005. In the argumentation, though, China is not

<sup>17</sup> The extensive issue cannot be dealt with at length in this context. For a more detailed analysis see Dröge, S. (2008) „Klimazölle“ und die Glaubwürdigkeit der EU Klimastrategie. SWP Berlin; Hufbauer, G., S. Charnovitz & J. Kim (2009). Global Warming and the World Trading System. Peterson Institute for International Economics; Deutsch, K. (2008). Cap and trade in America: US climate policy at a crossroads. Deutsche Bank Research. Current Issues. Frankfurt am Main. May 5, 2008.



### Difficult to pass judgment on the major trading currencies

### On the brink of competitive devaluation?

depicted as a currency manipulator.<sup>18</sup> Nonetheless, in view of the current crisis, the debate could take on a more hawkish tone.

Various other currencies, mainly those of emerging markets that are major exporters of commodities, have depreciated significantly versus the US dollar since mid-2008. This needs not necessarily be the result of a devaluation drive. The depreciation may instead be attributable to market economics, since investors have become increasingly risk averse. As a consequence, there had been a “flight to safety”, to the presumably safe haven of the US dollar, which resulted in the appreciation of the US dollar and the depreciation of the currencies of some emerging markets.

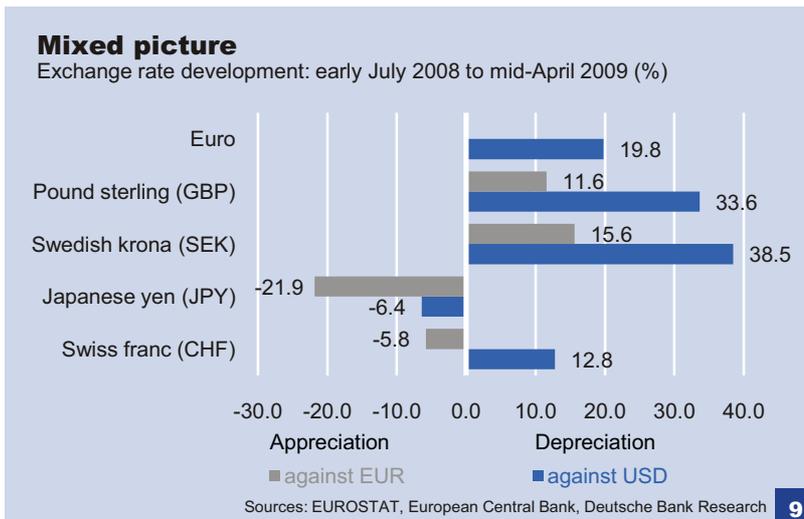
The depreciation in certain exporting countries also has to be viewed in connection with the plunge in commodity prices. This caused their inflows of foreign currencies to decrease and the related exchange rates were no longer sustainable on unchanged demand for forex reserves – downward pressure on the currency evolved. Since the central banks of some countries were no longer prepared to continue using forex reserves to stabilise their currencies – after initial willingness to intervene – they allowed their respective currency to depreciate by as much as 20-40% in no time at all. So when these currencies depreciated, the intention was more to shore up the individual country’s forex reserves than to actively promote exports in a way that served protectionism. Supply and demand for foreign currencies were to be returned to a semblance of equilibrium.

The picture that emerges for the major trading currencies is mixed. The pound sterling has lost considerable ground versus the euro since mid-2008, and even more so versus the US dollar. The euro has also depreciated against the US dollar in the same time frame. The Japanese yen, by contrast, has appreciated strongly against the US dollar and even more significantly against the euro. The extent to which these shifts are attributable to active currency manipulation by the respective governments is hard to say, however. The Swiss National Bank is the only central bank that actively weakened its currency via foreign exchange transactions; it intervened in mid-March to prevent the further appreciation of the Swiss franc and help fight the recession.<sup>19</sup> However, this must be seen against the backdrop of the Swiss franc having risen substantially against the euro since the beginning of the crisis and causing an additional drag on the Swiss economy. Despite the intervention the Swiss franc has still trended up against the euro since mid-2008; it has only depreciated against the US dollar. This supports the argumentation of the Swiss National Bank that its intervention was meant to stabilise the exchange rate rather than to distort it actively.

Such developments notwithstanding, how serious is the risk – considering the significant shifts on the foreign exchange markets – that the world’s economies could slip into a round of competitive devaluation similar to that witnessed during the Great Depression of 1929-1933? At the time, as already pointed out, major trading nations such as the United Kingdom, the United States and France abandoned the gold standard and deliberately devalued their currencies. Combined with the wave of protectionism this subsequently led to the slump in world trade as discussed.

<sup>18</sup> U.S. Department of Treasury (2009). Report to Congress on International Economic and Exchange Rate Policies.

<sup>19</sup> Swiss National Bank. Press release on March 12, 2009.



**Difficult to envision effects of devaluations**

The risk of a similar development materialising today has to be viewed, however, against the backdrop of the changes in the general environment. Today, unlike during the days leading up to the Great Depression, there is no regime of fixed exchange rates. Instead, diverse systems determine the exchange rates of the individual currencies to the US dollar and the euro. The euro-dollar rate, in turn, can float freely. A key feature of a flexible exchange rate system is that, in principle, the central banks do not intervene in the forex markets and exchange rates are determined by supply and demand in these markets. This can only result in competitive devaluation if the central banks abandon their hands-off policy and intervene in the forex market.

The effects of such intervention are difficult to envision in today's globally integrated world, however. Much of world trade takes place on an intra-industry basis, for exporters now often import their factor inputs or services. This means they are equally hard hit by a devaluation of their own currency because their imports become more expensive. Besides, they would be confronted with rising transaction costs in international trade as a result of higher exchange rate volatility. Logically, they are not going to urge their governments to devalue. Even if they did, however, many countries would have little scope for further depreciation since this would require renewed interest rate reductions, but interest rates have already been lowered significantly in order to boost demand.

In addition, several major trading nations have joined forces in the euro area and created a monetary union, ruling out any possibility of their engaging in competitive devaluation. So the upshot is that there is a smaller risk of competitive devaluation today than there was back then.

**2.4 National economic stimulus packages**

Other measures for coping with the crisis harbour protectionist potential, too. The massive use of taxpayers' money to prop up business puts pressure on policymakers to deploy the aid strictly for the national economy. For in light of the openness of many economies today much of the money made available via demand stimuli often flows abroad via imports, and thus foreign companies benefit from the domestic stimulus packages. Moreover, there is a risk that individual countries will attempt to benefit from other countries' fiscal packages without having to pay out of their own pocket for the boost in demand. In this case, the buzzword is free-

**"Buy American" provision**

The "Buy American" provision of the American Recovery and Reinvestment Act of 2009 refers to the purchase of iron, steel and other building materials in government procurement tenders. Section 1605 of the new legislation provides for the following: "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." Section 604 adds: "Except 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."

Such provisions are nothing new: up to now, US suppliers have been awarded government contracts as long as their offers have not exceeded those of non-US suppliers by more than 6-9%. The minimum mandatory share of local production used to be 51%. The current US stimulus package tightens this rule substantially, however: domestic suppliers are now awarded a contract as long as the use of their products does not increase the overall expense of the project by more than 25%. Because procurement is calculated in relation to the costs of the overall project, this is tantamount to an over 25% import tariff for foreign suppliers and effectively closes the market for iron, steel and further manufactured goods. In addition, there is no clear legal definition for the wording "manufactured goods" and "produced in the United States" found in Section 1605. This could allow the local production share to be boosted to nearly 100%. The legal uncertainty might have a distortionary impact itself, however. Besides, US suppliers that use imported intermediates would also be affected.

In order to make these rules comply with the WTO regime, the two sections were retroactively supplemented with a further provision: "This section shall be applied in a manner consistent with United States obligations under international agreements." This means that the provisional rules released at the end of March exclude some of America's trading partners from the "Buy American" rules: this applies to all 38 signatories (including Germany) to the WTO Agreement on Government Procurement, as well as partners from free trade agreements such as NAFTA and diverse developing countries.

Sources: WTO (2009). JOB(09)/30; DIHK/BDI. Washington News No.13/09

### Need for international coordination of aid

riders. This in fact underpins the tendency to confine aid to the domestic market via protectionist clauses. The issue becomes increasingly politicised and the national decision-makers respond to the preferences of their electorate. Such a turn of events would be likely to cause problems especially in a single market such as the EU. This highlights the urgency of seeking early and extensive coordination of national measures so the openness of the national submarkets will not be jeopardised.

The risk of policymakers succumbing to the temptation of offering direct subsidies in such an environment has already been flagged. But there is more to it than that: one issue in this context, for example, is the "Buy American" provision in the US stimulus package. It stipulates that public infrastructure projects should only use iron and steel from US makers, as long as using their products does not raise the overall costs of a project by more than 25% (see box). France made its aid for the auto industry contingent on the recipients' commitment not to close any plant in the domestic market. Among the political reactions, Paraguay's response is typical, even though the economic ramifications are much less significant: its "Buy Paraguayan" plan establishes a 70% preferential margin for domestic firms in government procurement.<sup>20</sup>

Even if these provisions are partly watered down retroactively, the call to concentrate on the home market might influence other business decisions and consumers, thus leading to competitive distortions and inefficiencies.<sup>21</sup> Equally, the associated cooling of relations between the countries involved might have a more serious impact than the economic consequences of such provisions themselves, considering that, for example, the import share in US government procurement up to now has come to a mere 4%.<sup>22</sup> A contrasting example would be public procurement in the EU, where the markets have been substantially deregulated over the past few years and invitations to tender are required to be called EU-wide from certain value thresholds. It is acceptable to raise these thresholds – moderately – in the framework of the coordinated economic stimulus packages as long as the arrangement is only temporary. Here too, though, there is a risk of creeping renationalisation and thus of long-term related efficiency losses and stunted growth.

To address this risk of protectionism it is essential to coordinate the national stimulus packages at the international level. If a country's exports rose on the back of stimulus packages in other countries, this would offset the rise in imports triggered by its own demand stimuli. Better coordination is also likely to increase the effectiveness of the national measures: the United Nations forecasts that through internationally coordinated fiscal packages worth 1.5-2% of the GDP of the world's biggest economies the developed countries could reach a growth rate of 0.2% and the developing countries a rate of just over 5% in 2009.<sup>23</sup> In the final communiqué of the G20 London summit the heads of state and government of the world's leading economies pledged to act together cooperatively to support the global recovery with a USD 1.1 trillion stimulus programme while ensuring that their national crisis measures do not have any

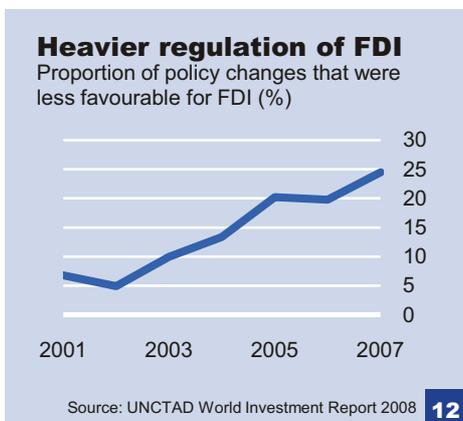
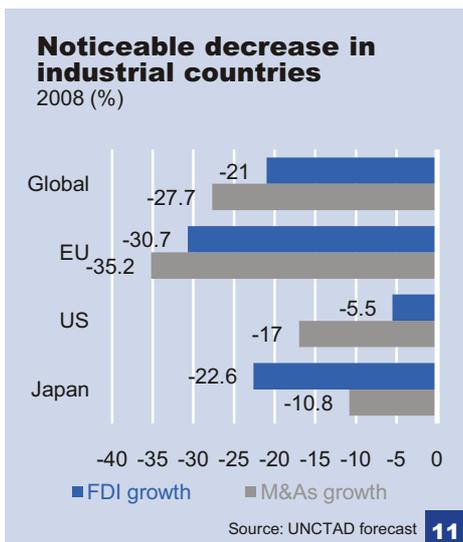
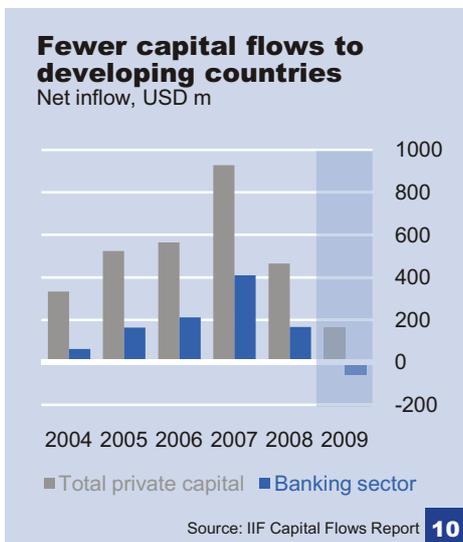
<sup>20</sup> WTO (2009). JOB(09)/30.

<sup>21</sup> One example of this can be seen by visiting: <http://howtobuyamerican.com/index.php>

<sup>22</sup> Hufbauer, G. & J. Schott. (2009). Buy American: Bad for Jobs, Worse for Reputation. Peterson Institute for International Economics.

<sup>23</sup> United Nations (2009). World Economic Situation and Prospects 2009. New York.

**Ironic twist of history**



negative impact on global trade. It is difficult to foresee, however, to what extent the commitments will have an impact in view of the fact that there is no detailed binding content.

The protectionist threat harboured in national stimulus packages discussed above is a new aspect compared to the Great Depression of 1929-1933. This is an ironic twist of history: the current threat emerges from the lessons learnt in the 1930s. In those days, the countries resorted to restrictive fiscal policies and in so doing they exacerbated the slump in demand. In order to prevent history repeating itself, most of the countries today have adopted an expansionary fiscal policy which – if this is not done in a coordinated manner – will entail the above-mentioned risks of restrictions on competition and trade. Combined with the subsidy contest the protectionist tendencies of the current economic stimulus packages could significantly amplify the collapse in world trade.

**2.5 Restrictions on international capital flows**

Besides the collapse of trade in goods and services, a decline in international capital flows is also on the cards. According to the Institute of International Finance (IIF) the emerging economies will see net private capital inflows fall to USD 165 bn in 2009 after having peaked at USD 929 bn in 2007 and already easing to just over USD 400 bn in 2008. For the banking sector, the IIF expects the emerging economies in fact to register a net outflow, i.e. debtors will pay back more loans than they borrow.<sup>24</sup> UNCTAD says that foreign direct investment (FDI) also declined in 2008, by 21% worldwide, while cross-border mergers and acquisitions were down by 27.7%.<sup>25</sup>

Apart from market reasons such as a liquidity squeeze, financing bottlenecks and higher risk aversion, one factor driving the decline in the current crisis may be a politically motivated increase in restrictions on international capital flows. For example, even before the financial crisis started there was a trend towards heavier regulation of FDI. In the area of natural resources, in particular, governments have sought to not lose national control. Australia, for one, reviews Chinese investment bids in the mining sector for conflicts with its own national interests. In December 2008, India enabled foreign investors to take larger stakes in various sectors of the economy as a way to deal with the crisis; however, this liberalisation move was partially revised in February 2009 and the government introduced caps on foreign investment in sensitive sectors such as defence, telecommunications and aviation.<sup>26</sup>

UNCTAD reports that while the overall number of trade restrictions has fallen, the proportion of rules that are unfavourable for FDI has increased, from about 5% of the total in 2002 to nearly 25% in 2007.<sup>27</sup> Examples of non-tariff barriers to trade in this segment include nationality and domicile requirements, limits on non-residents' equity holdings and restrictions on certain types of business organisation. Moreover, the plans for governments to take stakes in the national bank bail-out programmes narrow the scope for FDI in the financial sector, and potential restrictions on dividend payments weigh on its attractiveness.

<sup>24</sup> The Institute of International Finance (2009). Capital Flows to Emerging Market Economies.  
<sup>25</sup> UNCTAD (2009). Assessing the impact of the current financial and economic crisis on global FDI flows.  
<sup>26</sup> WTO (2009). JOB(09)/30.  
<sup>27</sup> UNCTAD (2009). loc. cit.

**Tightened regulations might obstruct recovery**

The building of barriers to FDI is problematic regardless of whether it happens in the source country or in the recipient country. The diverse rules increase the costs of financing FDI, impairing its allure. This prevents foreign investors from entering the market even if they might be able to conduct the respective business activities more efficiently and successfully than domestic players do. In addition, new financing bottlenecks could develop if countries link their bank bail-out plans with obligations to favour domestic loan applicants.

Such politically motivated restrictions on capital flows lead to general investor uncertainty. Thus they have longer-term effects than the market-induced decline in capital flows seen in the current economic and financial crisis. What is more, they could permanently obstruct a recovery in the markets if the authorities launch excessively tight regulations that can only be revised with difficulty later.<sup>28</sup>

**2.6 Cutback on growth driver migration**

Against the backdrop of the economic crisis and rising unemployment, calls for constraints on immigration are also growing louder in some countries. It is argued that unemployment could be stopped from rising further by giving preference to nationals to fill job vacancies and showing foreign nationals the door. Several surveys reflect this sentiment: according to a Harris poll commissioned by the Financial Times, nearly 80% of the respondents in Italy and the UK would strongly or partially support their respective government if they asked jobless immigrants to leave the country. In Germany and the US the shares are 60-65% no less, while in France, by contrast, the share is only about 50%.<sup>29</sup> Strikes broke out in England in January to protest against the hiring of Portuguese and Italian workers at an oil refinery.

**Immigration is increasingly being cut back, ...**

And politicians seem to be bowing to this pressure from the streets: the US obliges recipients of aid from its economic stimulus package to favour US citizens over foreigners with an H-1B visa with regard to employment. At the time of writing, Congress was debating the pros and cons of extending this rule to all US firms.<sup>30</sup> The UK announced an immigration tax in mid-March 2009 requiring immigrants from outside the EU to pay GBP 50 for their visas. Spain backed out of an agreement allowing Philippine workers to take up employment in the health sector. In January 2009, the Malaysian government prohibited the hiring of foreign workers for factories, department stores and restaurants and annulled the visas of 55,000 workers from Bangladesh in order to protect the domestic labour force.<sup>31</sup>

**... but migration may help bring about a recovery**

Various experts warn that such limitations on migration will make it more difficult to find a way out of the crisis and that the waves of migrants returning home could worsen the recession in developing countries and emerging economies. Back in October 2008 UN Secretary-General Ban Ki-Moon had cautioned against limiting the mobility of labour in times of recession because it could be a vital

<sup>28</sup> However, in some cases opposite trends can be observed, for example, when sovereign wealth funds from emerging markets are welcomed as financially healthy investors for companies that have fallen into dire straits because of the economic crisis.

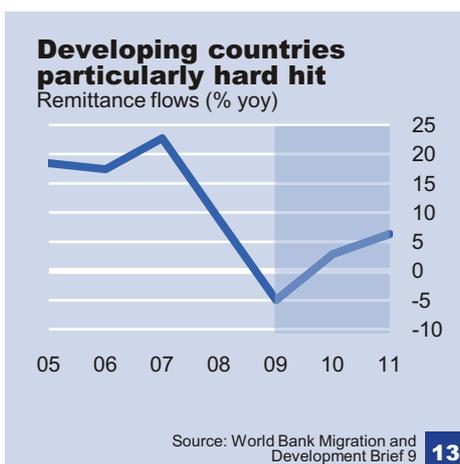
<sup>29</sup> Barber, T. (2009). Jobless migrants should leave, say many in EU. Financial Times. March 16, 2009.

<sup>30</sup> Watanabe, T. (2009). Visa program for skilled workers under attack. Los Angeles Times. April 1, 2009

<sup>31</sup> Mogato, M. (2008). U.N. says labor mobility key to tackling global crisis. Reuters. October 29, 2008.

## Migration is a growth engine

### Volume of remittance flows will fall for the first time again in 2009



element in the ensuing recovery.<sup>32</sup> Labour mobility ensures that the right talents can reach the proper place at the proper time and thus often cushions the impact of a crisis. The IMF also determined in October 2008 that labour mobility in the EU promotes the process of convergence among the member states as remittance flows to families who stay behind and returning workers with higher skills help to drive the development of these countries.<sup>33</sup>

Businesspeople now seem to have realised that migration is a growth engine: at the end of 2008, KPMG surveyed firms from 11 major economies on the demand for skilled foreign workers: 82% stated that better labour mobility gave them a greater pool of talent from which to choose. 73% said that this enabled them to hire higher-qualified employees. Some 69% affirmed that hiring people from foreign countries fosters better understanding of global markets.<sup>34</sup> Microsoft opposes the tightening of visa rules in the US and points out that 35% of the US patent applications it filed in 2008 came from visa or Green Card holders.<sup>35</sup> However, it is dubious as to what extent this insight can prevail in the rest of society considering the way the ranks of the unemployed are growing.

One key aspect of migration is remittance flows from immigrants to their families at home. In 2008, at a total of USD 305 bn, these remittance flows already surpassed the volume of development aid. However, these flows are also on the decline: as recently as 2007, the annual increase came to over 20%. For 2009 the World Bank expects remittance flows to shrink by 5% in its baseline scenario, and in fact by as much as 8.2% in the pessimistic scenario. The implications for the developing countries become clear with a look at the following figures: remittance flows account for 48% of GDP in Tajikistan, 38% in Moldavia and 24% in Lebanon.<sup>36</sup> However, an emerging economy such as Mexico, whose second largest source of foreign exchange after oil in 2008 was remittance flows totalling USD 23 bn, could be seriously hit by the decline as well. Of course, the decrease is mainly attributable to a market reaction, because the demand for labour has plunged on the coat-tails of economic activity in the crisis. However, limitations on migration additionally worsen this development.

### 3. Conclusion and calls on policymakers

In the preceding discussion it clearly emerged that a comparison of the protectionist measures in the current economic crisis and those in the Great Depression of 1929-1933 is only partially warranted. There is a much smaller risk of the crisis worsening to a similar degree today on the back of the same protectionist measures as back then. Tariff hikes and currency devaluations are far less attractive now because of the changes in the interim in (global) economic structures and the arrangements within the WTO. These factors weigh not only on foreign exporters but also on the domestic companies integrated into the international value-added chain. This is why the lobby that supports the traditional protectionist strategies

<sup>32</sup> Mogato, M. (2008). loc. cit.

<sup>33</sup> IMF (2008). Regional Economic Outlook Europe: Dealing with Shocks. Washington.

<sup>34</sup> KPMG International (2009). Tax, Demographics and Corporate Location.

<sup>35</sup> <http://microsoftontheissues.com/cs/blogs/mscorp/archive/2009/03/30/appreciating-our-immigration-system.aspx>

<sup>36</sup> Ratha, D. and S. Mohapatra (2009). Revised Outlook for Remittance Flows 2009-2011. Migration and Development Brief 9. World Bank.

has noticeably shrunk, at least in the established industrial countries.

### **Target of protectionism shifting**

This argumentation must not lull anyone into underrating the protectionist risk in the current crisis per se. At times of collapsing demand, countries and companies will continue to resort to measures which make their product more competitive. Even if they do not choose the conventional channels of the past, there is still a considerable risk that new forms of protectionism will intensify the downswing in a similar way. These primarily include the subsidy contest discussed above in combination with national economic stimulus packages. As it turns out, the target of protectionism is shifting away from discrimination against foreign competitors via the imposition of tariffs towards active preferential treatment of domestic companies via subsidies and more or less hidden appeals to buy goods and services produced in the home market. In this case the logic of intra-industry trade cannot be used as a counterargument, since subsidies place no limits on the domestic companies in their intra-industry trade. So this also nurtures a big lobby which supports this form of protectionism. In times of greater international integration and intra-industry trade, the looming subsidy contest could metamorphose into the tariff race seen back then – with similar consequences for world trade. The fact that budget restrictions put certain limits on such a subsidy battle does nothing to reduce its contentiousness. For the more the spirit of free trade is violated, the sooner protectionist tendencies are likely to escalate with the imposition of retaliatory measures in the emerging markets, for example. A study conducted by the Peterson Institute for International Economics concluded that the creation of 1,000 jobs via the “Buy American” provision can result in up to 65,000 lost jobs via a slump in exports in the wake of retaliatory measures.<sup>37</sup> And the risks harboured by other non-tariff barriers to trade, such as tightened environmental safety rules and greater restrictions on capital flows and migration, must not be underestimated.

### **It is vital to secure medium-term growth opportunities**

These factors threaten to unleash a spiral of protectionism that perhaps may not choke off the recovery of the global economy entirely but at least partly delay its advance. As an ironic twist of history would have it, monetary and fiscal policymakers learned the right lessons from the Great Depression, but now, however, these lessons have given rise to new risks in the form of trade-distorting measures. A general insight applies just as much today as it did then: government policymakers must not sacrifice medium-term growth opportunities for near-term protection of the status quo. Logically, shoring up open markets and free trade is the next major challenge in a globally coordinated drive to cope with the crisis. Besides the undoubtedly important focus on measures directly discriminating against foreign competitors (tariffs), it is essential to focus more closely on measures directly favouring domestic players (subsidies).

Tim Sprissler

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<sup>37</sup> Hufbauer, G. & J. Schott.(2009). loc. cit.

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