ARTICLE – The economic consequences of increased protectionism

In recent years, support for free trade has declined in some parts of the world and new trade barriers have arisen. The US president has declared that he is willing to circumvent or ignore internationally-agreed regulations and to introduce high tariffs. In Europe, parties with a protectionist agenda have gained increasing support in the opinion polls. At the most recent G20 meeting, the explicit vow to resist all forms of protectionism that has been included in the communiques following every summit meeting was omitted for the first time since the global financial crisis. Increased protectionism in the world would slow down global growth and probably reduce demand for Swedish exports. At the same time, inflation may become higher in those countries in which trade barriers are raised.

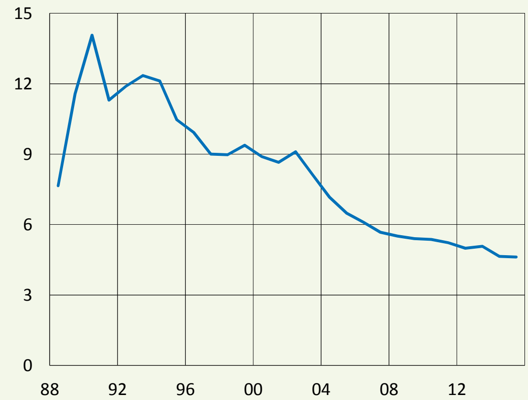
During the Great Depression of the 1930s, many countries used trade barriers to protect their economies and thereby aggravated the deep recession in the world economy. In an attempt to prevent a repeat of these experiences, the multilateral trade agreement GATT (General Agreement on Tariffs and Trade) was signed in 1947.

Since then a further seven multilateral trade negotiation rounds have been held, and the most recent one led to the establishment of the World Trade Organization (WTO) in 1995, which now has 164 member countries.[31] Through the agreements, the member countries have, by lowering their trade barriers, given other countries greater access to their markets and they have received greater access to the other countries' markets in exchange.

A number of regional and bilateral integration agreements have also been signed in recent decades. This includes the EU and the free trade agreements the EU has with several neighbouring countries, as well as NAFTA (the North American Free Trade Agreement) between Canada, Mexico and the United States.

Figure 4:17. Average tariff level

Per cent

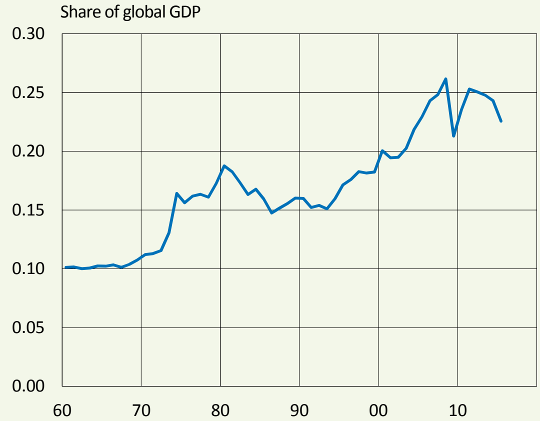


Note. Import-weighted average of applied tariff rates

Sources: WITS (UN statistics division, UNCTAD, WTO and the World Bank)

Figure 4:18. Global imports of goods

Share of global GDP



Sources: WTO, the World Bank and the Riksbank

The results of the long liberalisation trend

All in all, the multilateral and regional trade agreements have meant that the average global tariff level has been reduced considerably, from over 20 per cent at the time of the first GATT to around 5 per cent today (see Figure 4:17).[32]

This 70-year history of multilateral and regional trade agreements has contributed to global trade growing in significance for the world economy as a whole (see Figure 4:18).

[31] In 2001, the so-called Doha round was initiated, but it has not yet been concluded.

[32] For estimates of the average global tariff level at the time of the first GATT, see further WTO (2007), World Trade Report – Six decades of multilateral trade cooperation: What have we learnt? and Bown, C. P. and Irwin, D. A. (2015), "The GATT's Starting Point: Tariff Levels circa 1947", National Bureau of Economic Research, Working Paper 21782. In addition to tariffs, there are a number of different trade barriers which may have substantial effects that may be difficult to measure. The GATT therefore includes a number of clauses aimed at limiting the use of other trade barriers and where necessary replacing them with tariffs. See further Staiger, R. (2012), "Non-tariff Measures and the WTO", WTO Staff Working Paper, ERSD-2012-01.

Freer trade has also contributed to consumers around the world gaining higher real incomes and access to a larger supply of goods and services.[33] Their real incomes have become higher because international trade benefits productivity, that is, makes it possible to get more out of the available resources.[34] One reason is that freer trade increases the possibilities for international specialisation – countries can produce more of the goods and services that make the best use of their particular assets in the form of available land, capital, labour and natural resources.

Within individual sectors, international trade may moreover have benefitted more productive companies at the cost of less productive companies.[35] The possibility to reach a larger market also appears to stimulate innovation,[36] at the same time as free trade gives companies the opportunity to access potentially cheaper and better supplies of input goods. The productivity of the individual company may also benefit from being exposed to greater competition from abroad.[37]

However, liberalisation of trade could simultaneously disadvantage parts of the population. Goods that require a relatively large input of labour in their production (such as clothing) tend to be relatively cheap to manufacture in countries where there is a large supply of low-skilled labour. When trade is liberalised, the developed economies therefore increase their import of labour-intensive production from these countries. The domestic low-skilled labour thus indirectly meets increased competition from the low-skilled labour in other countries, and is forced to accept lower real wages or, in the worst case, unemployment. It would probably suffice to distribute part of the profits falling to other groups to compensate those losing out on freer trade. However, in practice, it is difficult to design a functioning model for compensation.[38]

Tendencies towards increased protectionism

There may thus be groups who feel that free trade disadvantages them. In addition, opinion in favour of more protectionist policies tends to become stronger in conjunction with economic crises, as happened in the 1930s, in connection with the Great Depression. The G20 countries have therefore emphasised the importance of not following this pattern in the wake of the global financial crisis.

Nonetheless, there are signs that protectionist measures have become more common in recent years (see Figure 4:19). This is not primarily a matter of tariffs but of the introduction of different types of trade barriers, whose effects are more difficult to judge. At the same time, political representatives with a protectionist agenda have gained ground in several parts of the world. The US president has declared himself willing to introduce high tariffs for certain countries and, at the last G20 summit, the clear rejection of protectionism was left out of the joint communique for the first time.

Existing agreements restrict possibilities for protectionist behaviour to some extent

The great majority of countries of greater significance to the development of the world economy or the Swedish economy are members of the WTO and participate in various forms of regional integration agreements, such as free trade agreements. These agreements generally have clauses regulating cancellation or withdrawal. For NAFTA, a period of notice of six months applies, which is a common arrangement in international agreements. For the EU, which involves more far-reaching integration, the corresponding period between notification and withdrawal is two years. So far, it has been highly unusual for countries to leave a regional integration agreement – the upcoming British withdrawal from the European Union is an exception.

If a country withdraws its membership of a regional integration agreement, it is still subject to its commitments as a WTO member. Under the prevailing WTO agreement, tariffs may not be raised above the levels to which a country has committed and, if any country is offered lower tariffs, this must also apply to all other countries. If, for example, the United States were to leave NAFTA, it could introduce tariffs towards Canada and Mexico up to the levels it has committed to under the WTO. Towards Mexico, this would mean an average tariff increase of about 4 percentage points, which is to say significantly less than the 35 percentage points mentioned during the presidential campaign.

A US president could, theoretically, under US legislation, initiate tariff increases above and beyond this without the explicit support of Congress. This could be done by citing national security interests or a large current account deficit.[39]

[33] For an overview and interpretation of empirical studies in this field, see Goldberg P. and Pavcnik, N. (2016), "The effects of trade policy", Chap. 3 in Bagwell K. and Staiger, R. (eds.), Handbook of Commercial policy, New York: Elsevier North Holland.
[34] Ibid. and IMF (2016), "Is the Trade Slowdown Contributing to the Global Productivity Slowdown? New Evidence", Box 2.1. in World Economic Outlook, October 2016.
[35] See Melitz, M. (2003), "The Impact of Trade on Intra-industry Reallocations and Aggregate Industry Productivity", Econometrica, vol. 71, no. 6, pp. 1696-1725.
[36] The way that imports from China affected technology and productivity in OECD countries is described in Bloom, N., Draca, M. and Van Reenen, J. (2016), "Trade Induced Technical Change? The Impact of Chinese Imports on Innovation, IT and Productivity", Review of Economic Studies, vol. 83, no. 1, pp. 87-117. The effects of the 1990s trade liberalisation on global innovation tendencies have been estimated by Coelli, F., Moxnes, A. and Ulltveit-Moe, K.-H. (2016), "Better, Faster, Stronger: Global Innovation and Trade Liberalization", Centre for Economic Policy Research, Discussion Paper 11506.
[37] Helpman, E. and Krugman, P. (1985), Market Structure and Foreign Trade: Increasing Returns, Imperfect Competition, and the International Economy, MIT Press.
[38] Feenstra, R. C. (1998), "Integration of Trade and Disintegration of Production in the Global Economy", Journal of Economic Perspectives, vol. 12, pp. 31-50. Various forms of labour market programme are often mentioned as ways of compensating for trade-related losses of income and to facilitate employability within expanding sectors, see further OECD (2005), "Trade-adjustment Costs in OECD Labour Markets: A Mountain or a Molehill?", Chap. 1 of OECD Economic Outlook.
[39] Hufbauer, G. C. (2016), "Could a President Trump Shackle Imports?", in "Assessing Trade Agendas in the US Presidential Campaign", Peterson Institute for International Economics, Briefing 16-6. The WTO regulations also allow higher tariffs than agreed under such circumstances. Moreover, countries may have the right to protect

However, if this were to be carried out, the affected countries would probably claim a breach of the WTO's regulations and gain the right to adopt measures reducing the United States' access to their markets to a corresponding extent. There also exists a possibility for a country to entirely leave the WTO partnership.[40] In such a case, the country would no longer be subject to the tariff limitations agreed but would at the same time risk facing higher tariffs than those applying to WTO members.[41]

The agreements regulating world trade could thus make it costly, but not impossible, for countries to take a more protectionist stance.

Effects of global protectionism

Widespread global protectionism would lead to a loss of the benefits brought about by previous trade liberalisation (see above). Global real incomes would fall and there would be a risk that the supply of goods and services would diminish.

Small economies like Sweden's would be impacted more than larger ones if the world, as a whole, started to restrict international trade. A significant part of Sweden's output is concentrated to goods and services produced on a large scale and sold across the entire world. In addition, Swedish consumption and output largely utilise imported goods and services.

Effects of bilateral trade wars

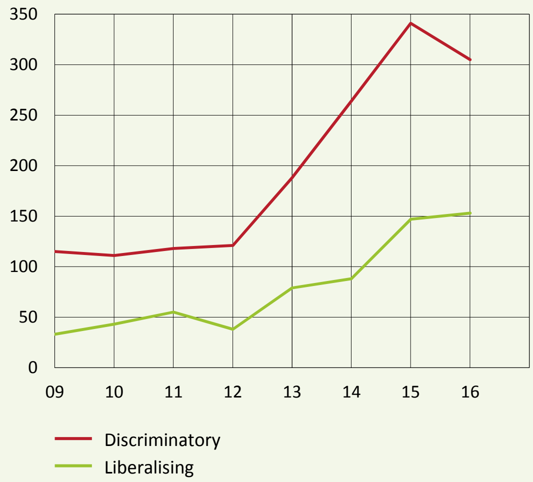
If the increase in protectionism is restricted to trade conflicts between specific countries, there would still be noticeable consequences for the global economy. A trade war between the United States and China would have a clear negative impact on both countries. In the short term, before trade and production patterns have time to adjust, the effects could be very extensive, not least in communities in which companies with close connections to international trade play an important part.[42] Over the longer term, the countries involved would have to deal with the efficiency losses following from impaired access to an important export market, as well as impaired access to part of the global output of iintermediate and consumer goods.

Other countries are also affected by a trade war between large economies. However, it is difficult to say in what ways and to what extent. In the short run, it can lead to problems for companies that are involved at some stage in the chain of production of goods traded between the USA and China.[43] A powerful reaction by the financial markets to a spiralling trade war could strengthen the negative effects on investment and consumption around the world. On the other hand, if the United States and China were to trade less with each other, they could come to trade more with other countries, such as Sweden.[44]

Increased protectionism would slow down global growth

All in all, increased protectionism would impede global output of goods and services and would probably reduce demand for Swedish exports. At the same time, more expensive imports of both consumer goods and input goods would lead to temporarily higher inflation in the countries raising trade barriers.

Figure 4:19. Trade-influencing measures introduced by G20 countries
Number



Note. Discriminatory (liberalising) measures are those measures that Global Trade Alert deems increase (reduce) discrimination in favour of domestic producers and are therefore colour-coded as red (green). Only measures both implemented and reported in the respective calendar year have been included. See also Evenett, S. J. and Fritz, J. (2016), "FDI Recovers? The 20th Global Trade Alert Report", Centre for Economic Policy Research, CEPR Press.

Source: Global Trade Alert

themselves against so-called dumping (selling goods below cost price), imports that are supported by unlawful subsidies, and too rapid import increases within a particular sector.

[40] Article 15 in the WTO treaty specifies that a country's membership of the WTO and participation in the accompanying trade agreements can be terminated after 6 months' notice in writing, see WTO (1994), Agreement Establishing the World Trade Organization.

[41] For a more detailed review of the principles behind and the functions of the world trading system in general and the WTO in particular, see Hoekman, B. M. and Kostecki, M.M. (2009), The Political Economy of the World Trading System: The WTO and Beyond, third edition, Oxford University Press.

[42] For a review of the possible effects of a trade war on cities and regions in the United States, see Noland, M., Robinson, S. and Moran, T. (2016), " Impact of Clinton's and Trump's Trade Proposals", in "Assessing Trade Agendas in the US Presidential Campaign", Peterson Institute for International Economics, Briefing 166.

[43] The effects of this depend on what expectations companies and participants on the financial markets have for how long-lasting a trade war may be. If it is expected to be short-term, those affected by higher costs for input goods and/or worsened conditions on a market may adjust their profit margins to some degree and the effects will be lesser than in the event of a trade war lasting for a longer time.

[44] Other countries' export goods would become slightly more competitive in the United States and China if Chinese and US goods respectively were to be subject to higher tariffs. In addition, purchasers of US (Chinese) goods and services would have less competition from Chinese (US) purchasers and could thus obtain more advantageous import prices.