Global trade in the aftermath of the global crisis

Jeffry Frieden
Harvard University

Re-balancing global trade will be difficult, generating substantial protectionist pressures. To manage these pressures, governments must maintain domestic political support for an open world economy. This in turn requires flexible responses to national political pressures. Rigid, unrealistic insistence on exemplary behaviour will be less fruitful than efforts at modest, feasible cooperation on trade policies. Above all, governments singly and jointly need to address the underlying macroeconomic causes of the imbalances to prevent serious trade confrontations.

The world trading system seems to have weathered the worst of the current crisis, but serious challenges are still to come. As the world moves toward recovery, adjustment to the new macroeconomic reality will create economic and political tensions both within and among nations. These tensions – and not the stalled Doha Round, or the proliferation of regional agreements, or specific protectionist pressures – constitute the most serious threat to an open trading order.

The effects of the post-crisis rebalancing on political controversies over international economic relations are the most immediate challenges we face in the international trade arena. As we move out of the immediate phase of recovery, the world's major economies face serious problems whose unfolding has important implications for global commercial relations.

The post-crisis environment

To understand the environment we face as we emerge from the crisis, it is important to clarify the background to the crisis itself. The ultimate cause of the current crisis was the global macroeconomic imbalances that accumulated over the course of a decade and more. The US, along with several other countries, ran major current account deficits and built up large external debts. This led, as is typical in the case of capital inflows, to an acceleration of economic activity, including a rise in the local relative price of nontradables; in particular, it led to a boom in financial and housing markets. External debt financing created consumption-led expansions, then booms, then bubbles; these eventually burst.

As the deficit countries adjust, they will have to compress consumption, investment and government spending, and they will have to increase output, savings, and government revenue. They will need to restrain wages. They will also, perforce, have to reduce their current account deficits. Governments will thus be under substantial pressure to reduce imports and increase exports.

These adjustment requirements are mirrored in the surplus countries. The run-up to the crisis was enabled by the policies of countries that had come to depend on substantial trade surpluses as their engines of growth. Many of the surplus countries' governments pursued explicit macroeconomic policies to encourage trade surpluses, such as keeping their currencies artificially weak or otherwise pushing producers toward export markets. Now that this pattern is no longer sustainable, at least to the degree that has prevailed for the past decade, they will have to reorient their economic activities, relying more on domestic markets and less on exports.

Adjustment difficulties

Both kinds of adjustment efforts, in deficit and surplus countries, will be difficult. Economic agents in the deficit countries, accustomed to easy credit and booming consumption, face austerity and slow growth at home. The search for new sources of growth will lead them to look more eagerly at export markets – and to look less favourably upon imports. In surplus countries, producers who have become accustomed to easy exports and little trade competition are likely to find the international environment much less welcoming. Markets that had previously absorbed all that they could produce are now much more constrained. At the same time, the traditional export-led economies are likely to face much less enthusiasm about openness to their products.

Protectionist pressures

In this context, there will be substantial domestic and international tensions over trade policy. In deficit countries, there will be protectionist pressures to try to reduce imports, and pressures to open foreign markets to increase exports. In surplus countries, there will be pressures from previously economically and politically dominant exporters to maintain government support for them in the face of external hostility. In all instances, the potential costs of adjusting to new economic conditions will create demands for government support.

These domestic pressures will inevitably lead to inter-state disagreements over trade. Over the next decade, it will be a major challenge to manage these disagreements. It is important to look at trade policy, and trade conflicts, as part of the broader international economic terrain upon which adjustments to new conditions are taking place.

The "re-balancing" through which the world will be going for the foreseeable future will put serious strains on the international trading system. Some of the most powerful influences on world trade come from outside the narrow trade policy arena. One such area is currency policy. The impact of monetary relations on international trade is widely recognised; the ability of countries' monetary policies to impose (commercial) externalities on others is clear. In this context, there is a need for the major countries and international institutions to attempt to work toward a common understanding of how to deal with currency misalignments in a way that does not exacerbate underlying trade disputes (see Frieden 2009).

Lesson from history

The historical record is particularly clear on how important currency misalignments can be for trade policy. As Barry Eichengreen and Douglas Irwin (2009) have recently shown, many of the protectionist measures adopted during the Great Depression of the 1930s were responding to developments in currency markets (Eichengreen and Irwin 2009). National producers who found themselves under substantial pressure due to "competitive devaluations" on the part of other countries demanded, and often received, countervailing support in the form of protectionist trade barriers. It is easy to imagine how currency movements – and in particular, the maintenance of very weak exchange rates on the part of major surplus countries – could provoke a protectionist backlash in other countries and regions.

Fix macro problems to avoid trade problems

This analysis suggests two important points for policy makers:

- First, governments singly and jointly need to address the underlying macroeconomic causes of the crisis, and to work together to attempt to smooth the way toward macroeconomic adjustment.

Some of the most trying tensions in international trade relations are likely to be the result of macroeconomic pressures, such as exchange rate misalignments; international collaboration to address and reduce these pressures will be central to lowering pressure on the trade regime itself. Ironically, then – but not for the first time – one of the most important ways to avoid a deterioration of international trade relations will be to pursue appropriate and collaborative macroeconomic policies.

- Second, given heightened political sensitivity to international trade relations, attempts to extend or expand the rule-making features of the WTO or other elements of the international trading system, while well-meaning and laudable, are likely to be irrelevant at best, and harmful at worst.

In an environment in which governments face powerful pressures to support their exporters and import competitors, simply insisting on adherence to the rules is of little or no avail. Governments owe their primary allegiance to their constituents, and demands that they address domestic economic distress will always outweigh demands to abide by international commercial obligations.

Adjustment to the aftermath of the crisis, and to the unwinding of the global macroeconomic imbalances, will put major domestic political pressures on governments. As these pressures spill over into trade policy, a rigidly legalistic response is likely to be counterproductive. While international legal or normative economic considerations might always insist on strict compliance with WTO and other commercial commitments as the notional first best, in the real world of political economy, insistence on the 'first best' can be a formula for disaster. Success in responding flexibly to powerful protectionist pressures – whether at the national or regional level – is better than failure at opposing them rigidly.

When countries collapse into conflict, it is not usually out of a purposive desire to harm their partners, but rather out of a desperate attempt to address pressing domestic political demands, demands which cannot be ignored without threatening national social and political stability.

In these circumstances, it would be a mistake to allow the best to be the enemy of the good. It would be counter-productive to be unyielding about abstract principles or pre-conditions for attempts to improve cooperation among governments. Governments facing severe domestic political constraints will find it impossible to make sacrifices on behalf of an intangible payoff. Truly multilateral agreements and rigorous compliance with international trade rules would be best, and highly desirable; but we should be prepared to settle for what governments find feasible in their current circumstances.

The way forward

The most productive way forward is likely to be to encourage imaginative and flexible policies on the part of major trading partners and international institutions. This means:

- Accommodating the needs of countries facing substantial payments difficulties as they attempt to reduce their current account deficits.
- Adapting to the concerns of strongly export-oriented countries being asked to open their markets more fully.

In both instances, the goal should be to achieve forward motion – or at least to avoid going backwards – while recognising legitimate concerns about domestic social and political cohesion (Frieden 2009b).

Conclusions

The world is going through a difficult re-balancing, with important economic, social, and political implications for almost all major nations. It is crucial for the world to maintain and strengthen an integrated international trading system. But simply insisting on playing by existing trade rules will have little impact.

As the world moves toward recovery, it confronts important issues with profound implications for the world's trading system – issues that risk inflaming political tensions within and between countries. Governments will have to address the underlying macroeconomic sources of the crisis, and build the bases for a healthier recovery and rebalancing of the international economy. Cooperation among major governments on macroeconomic policies will go a long way toward reducing pressure on international trade relations.

But governments will only be able to sustain their general commitment to international cooperation and economic integration if they can muster domestic political support for an open world economy. This in turn requires a nuanced, flexible, response to national political pressures. While uncooperative trade policies should be identified and combated, policymakers should recognise that governments cannot ignore their domestic constraints, but must work within them. Rigid, ultimately unrealistic, insistence on exemplary behaviour will be less fruitful than efforts at modest, feasible cooperation on macroeconomic and trade policies.

References

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About the author

Jeffry Frieden is Professor of Government at Harvard University. He specializes in the politics of international monetary and financial relations. Frieden's most recent book is *Global Capitalism: Its Fall and Rise in the Twentieth Century* (2006). He is also the author of *Banking on the World: The Politics of American International Finance* (1987), of *Debt, Development, and Democracy: Modern Political Economy and Latin America, 1965 1985* (1991), and is the editor or co-editor of over a dozen other books on related topics. His articles on the politics of international economic issues have appeared in a wide variety of scholarly and general-interest publications.