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REPORT ON THE STRATEGIC RESPONSE:

**PRELIMINARY REPORT ON THE IMPLICATIONS OF TRADE RELATED POLICY RESPONSES
TO THE ECONOMIC CRISIS**

Declassified

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This preliminary note by the Secretariat urges

- Continued resistance to all forms of protectionism, including both tariff and non-tariff measures,
- ...and a firm timetable for rolling back any such measures that have been introduced.
- Bringing to a successful conclusion a balanced and ambitious DDA that would provide a major boost to the global economy and send a powerful positive signal to world markets.
- Maintaining and strengthening assistance to developing and other badly affected countries, including through the Aid for Trade initiative.

Analysis by the OECD Trade Committee of the full range of policy responses to the economic crisis will continue in 2009, with a view to informing future policy decisions by governments.

Explaining (And Demystifying) the Steep Fall in Trade

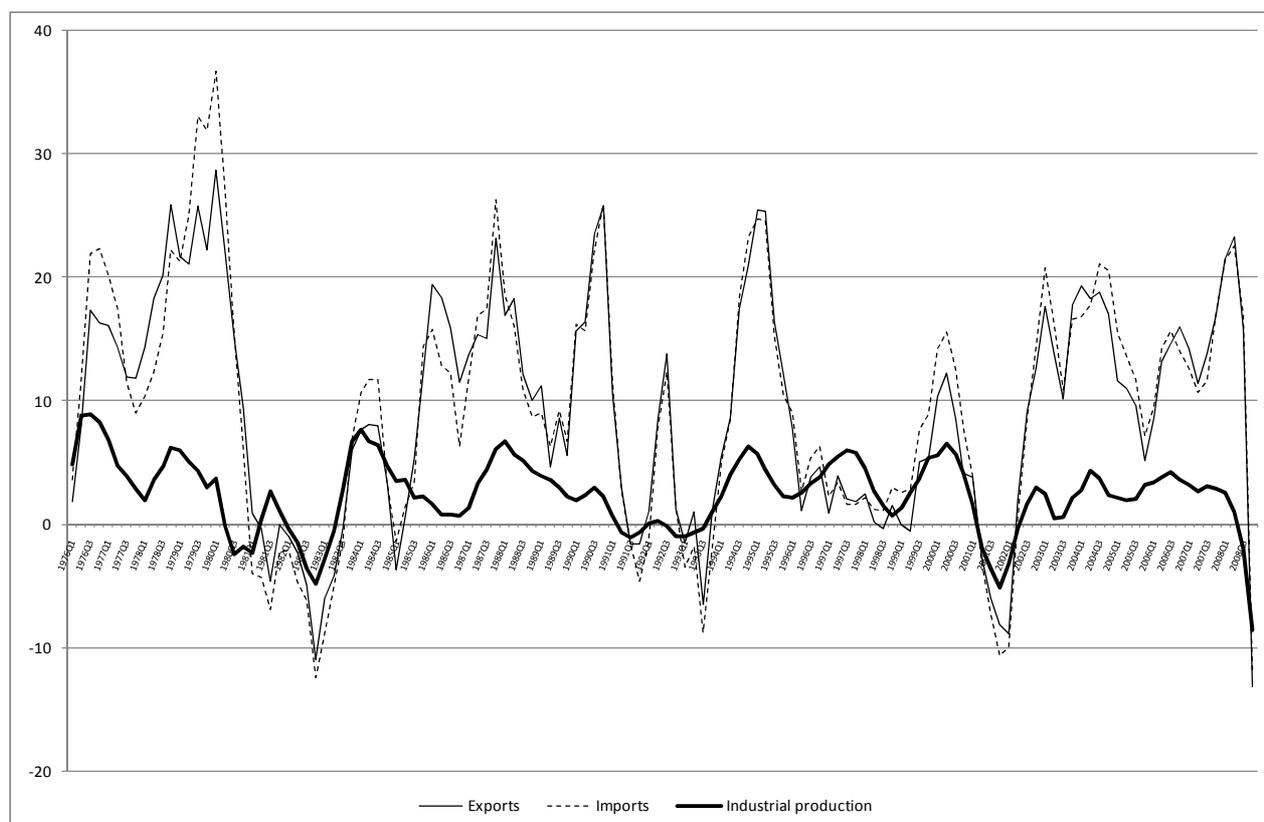
1. Trade fell sharply in the last months of 2008 and kept falling in the early months of 2009. In value terms, and compared with the same period in the previous year, total OECD area merchandise exports fell by 13.1% and imports by 12% in the last quarter of 2008. This contrasts with the third quarter of 2008, when these aggregates were still growing at robust rates of more than 15%. According to provisional data the fall has continued into 2009 but at less dramatic rates. The OECD is currently forecasting that the year-on-year fall in trade value in real terms in 2009 will be in the region of 13%. As shown in Figure 1, other economic downturns have also been associated with steep falls in trade, although the current decline would seem to be somewhat sharper than in earlier episodes.

2. What caused trade to fall? Several factors were at work but so far the available evidence suggests that the trade collapse was largely a consequence of falling demand, rather than its cause. As the financial crisis unfolded and credit dried up, so too did demand for consumer goods (e.g. cars) that are heavily dependent on the availability of credit. Risk-averse households started postponing discretionary purchases and began to save more. Rising joblessness has been adding to the weakness on the consumption side. Firms, big and small, have been cancelling or postponing investment decisions because they, too, are finding it difficult to get credit or are becoming more risk averse.

3. Preliminary analysis therefore suggests that the drop in trade, though much more dramatic, is, in a general sense, consistent with the drop in GDP. In Japan, the United Kingdom and the United States the decline in GDP growth rates preceded the fall in trade, while in Canada, France, Germany and Italy GDP and trade growth rates have been more or less synchronised. This would suggest that in some OECD countries falling import demand was an inevitable consequence of falling domestic demand, while in some more export-oriented OECD and non-OECD countries the output contraction may have been a result of falling foreign demand.

Figure 1. OECD area exports, imports and industrial production in historical perspective

(growth rate same period previous year)



Source: OECD Main Economic Indicators

4. Even if the relative magnitude of reduction in international trade is larger now than in the past, this is not unexpected. Indeed, trade as a proportion of GDP is known to increase over time as globalisation and fragmentation of production networks deepen. More than ever, production now involves the assembly of components that are manufactured in several countries and which may cross borders several times. At the most basic level, this increasingly international process is reflected by the increasing global ratio of trade to GDP. At the beginning of 1960s one dollar of value added generated worldwide was associated with approximately 12 cents worth of international trade flows, while in 2008 one dollar of value added was associated with more than 30 cents worth of international flows.

5. When interpreting trade data it is important to distinguish between value and volume changes. In many countries the drop in trade volumes is not as dramatic as in values (e.g. for Norway and Italy). Also, roughly half of the drop in nominal US imports over the 12 months ending in February 2009 was due to a drop in raw materials (e.g. oil) which was in turn driven mainly by the collapse in commodity prices (Francois and Woerz, 2009). There are also differences that can be seen across sectors. The bulk of the real drop in US exports was in motor vehicles and capital goods and this pattern is repeated elsewhere — once again providing some preliminary indications of a strong degree of consistency between GDP trends and trade trends.

6. Trade finance, on which a very large share of trade is dependent, also seems to have become increasingly difficult to obtain (as was credit generally). About 90% of trade transactions are financed through some form of credit, insurance or guarantee. The majority of trade is financed short-term (less than one year) generally through banks, although credit can also be granted directly by enterprises. Although it

is hard to disentangle cause and effect, there is no doubt that traders in need of short-term finance have been facing higher costs and generally increased difficulty in obtaining the necessary credit. Trade finance often involves transactions among banks, including local banks in the importing countries. The uncertainty which led to the reluctance of banks to do business with one another has been detrimental to short-term trade-finance flows. One indicator for trade finance is the volume of short-term export credits insured by the Union of International Credit and Investment Insurers, credit insurers in the 49 countries which accounted for about 10% of global trade in 2007. The growth of this indicator had turned negative by the third quarter of 2008 and was sharply negative through the end of 2008 and into the first quarter of 2009. It is not possible to determine whether the observed trends relate to tighter underwriting conditions, or the sharp fall in exports or some combination of these.

The Trade Policy Environment

7. We have seen that the dramatic falls in trade seem by and large to be consistent with, and explained by, developments in supply and demand, reflecting in turn the problems besetting credit markets and lower consumer and business confidence. Short-term trade-finance problems have likely exacerbated the situation.

Trade Finance and Export Credits

8. Members of the OECD Working Party on Export Credits and Credit Guarantees took policy action as early as autumn 2008 to facilitate the continuation of trade flows via the availability of official support for short and medium and long term export credits. OECD Members (as well as non Members) have domestically adopted a series of measures such as the provision of direct export finance, maintained or increased the potential volumes of official guarantees of export credits and insurances, facilitated access to their official support programmes, and provided new crisis-specific financial facilities. Collective action was also taken in the form of two successive Statements, in November 2008 and in April 2009 on an "OECD-plus" basis (with the participation of non-Members such as Brazil, China, Estonia, India, Indonesia, Israel, Romania, the Russian Federation and Slovenia and institutions such as the IMF, World Bank Group and the WTO. These Statements underline the determination of governments and the participating institutions to maintain export credit support and ensure that sufficient capacity is available with the aim of facilitating international trade flows. OECD will hold regular meetings to monitor the progress of trade finance and export credits and to facilitate the exchange of information on the measures taken.

Trade policy instruments

9. With respect to trade policy *per se*, major trading nations seem so far to have resisted the protectionist pressures that are inevitable when output slumps and employment is threatened. A relatively small number of countries have raised tariffs, usually in very specific sectors such as steel, footwear, or for some agricultural commodities. Virtually no country has resorted to a general increase in tariffs across multiple sectors. There are scattered examples of stronger import licensing; changes to technical measures that could be trade restricting; and increased resort to anti-dumping, countervailing and safeguard measures. Overall, there has not been a generalised resort to increased protection, but specific measures likely to impact specific sectors have been taken.

10. It would seem that the dangers of backsliding in the current environment are very well understood, as are the risks of disrupting complex global supply chains. There are even encouraging signs that countries fully understand the need for further reducing trade distortions as a way of overcoming short-term difficulties and better equipping their economies for a recovery in which trade will be an important factor. Several have actually reduced tariffs, sometimes in a targeted way, sometimes across the

board, most notably Mexico. Several others have taken the positive step of reducing or dismantling duties and taxes on exports. Of 140 measures reported by the WTO in March of 2009, almost one third were of a market opening nature.

Trade-related aspects of stimulus measures

11. Domestic measures also potentially have trade discriminating or distorting effects, both directly and because of the risks of retaliation that they create. The following paragraphs discuss these issues in general terms with respect to sectoral subsidies, government procurement and infrastructure spending.

Sectoral subsidies

12. Sectoral subsidies have significant potential to be trade distorting. Whether given in the form of grants, loans, employment subsidies, or tax breaks, they can be thought of and indeed expressed as production subsidies. They put other domestic industries that may be more efficient at a competitive disadvantage. Their distorting impacts on trade are compounded if other countries move to level the playing field by granting similar concessions to their competing industries. Sectoral subsidies will be even more distorting if they contain conditions that interfere with firms' decisions (e.g. as to where to produce in the case of multinational enterprises, or where to source inputs, or that explicitly discriminate between domestic and foreign firms and workers). Associated with such measures there is also a danger of retaliation which could take the form of direct increases in border protection or of matching sectoral subsidies.

13. As governments begin to reduce deficit spending and industries with over-capacity and in need of structural adjustment once again face competitive pressures, calls for increased border protection could intensify. Governments will need to be aware that, in the future, resisting calls to protect industries that have been lavishly aided may be even harder than is currently the case. Early planning for appropriate 'exit strategies allowing withdrawal of the measures taken in an orderly and timely way before they become entrenched, would be well advised.

Government procurement

14. Intense political pressure to include new "buy national" provisions — either in bailout packages or in governments' own procurement in the context of infrastructure projects — is increasing, but should not be yielded to. Such measures may lead to higher costs and inefficiency. Here also the dangers of retaliation are real. With many governments spending heavily on infrastructure projects, any significant resorting to economic nationalism is a serious threat to trade and ultimately to recovery. On the other hand, a concerted decision by countries not to resort to new "buy national" provisions could be an important signal of governments' commitments to the importance of open markets now and in the recovery period.

Infrastructure

15. Investments in physical infrastructure and in people provide one of the potentially least trade-distorting ways of boosting demand. At the same time, well planned investments would prepare the economy for the future when recovery begins and when having the competitive edge provided by better transport systems, better education and highly skilled people, or better telecommunications will matter for launching the global economy on a more sustainable growth path. This type of investment, provided there are no discriminatory provisions in procurement or contract allocation, avoid the trade-disrupting effects and the danger of retaliation that come with sectoral initiatives.

Aspects Affecting Developing Countries

16. While many developed countries have come up with large stimulus packages, equivalent to up to 5% of GDP in some cases, developing countries do not have the fiscal capacity to do likewise. If retaliation is triggered by these countries it is therefore much more likely to take the form of direct trade measures. For these countries the difference between applied and bound tariff rates is often larger than for OECD countries, but resort to such actions would be even more damaging to their own economies than to the countries targeted.

17. Developing and emerging countries are hit very hard by the collapsing trade flows. Efforts to assist low- and middle-income countries in the current environment of economic uncertainty and disrupted trade are crucially important. Development assistance in general, and Aid for Trade in particular, must be sustained and strengthened if less developed economies are to succeed in their development strategies to boost exports of goods and services, integrate further into the multilateral trading system and benefit from liberalized trade.

Policy Actions in the Short and Medium Term – Towards Some “Best Practice” Guidelines

18. Governments will need to continue to resist protectionist pressures and to explain their reasons for doing so. Pressures to resort to protectionist measures will not go away and can be expected to intensify if the economic crisis is prolonged and recovery delayed. Indeed, as governments begin to reduce deficit spending and industries in need of structural adjustment once again face competitive pressures, calls for increased border protection could intensify.

19. While it is always true, careful review of ‘policy packages’ is now especially important. Seemingly innocuous individual measures may sometimes combine with others to *de facto* mimic highly distorting policies. For example, a tariff increase combined with a consumption subsidy is essentially the same as a unit production subsidy. Policies for greener growth should also avoid trade protection either with the aim of shielding domestic environmentally friendly industries or of restricting trade of allegedly environmentally unfriendly products as part of a policy package. The impact on economic decision making of the whole range of incentives (and disincentives) warrants continued attention.

- **The most immediate policy response needed today is to continue to resist protectionist pressures so as to avoid damaging one’s own economy directly and to avoid a retaliatory spiral that would be damaging for all.**

20. The determination not to increase protectionism directly will be most effective if it covers WTO legal measures as well as those that are clearly illegal or of doubtful legality. Recent studies show there would be substantial costs if all tariffs were raised from currently applied levels to maximum allowed bound levels, even before taking any account of the negative impact that policy volatility of this kind would have on the confidence of traders who need as much predictability as possible in order to continue doing business.

- **Efforts to resist protectionist pressures should extend to non-tariff measures such as import licensing, export duties and restrictions, export subsidies, buy-local initiatives, and new or changed technical regulations with protectionist intent or discriminatory impact. This should include green protectionism.**
- **To the extent that trade-distorting measures have already been put in place they should be rolled back or a firm timetable for their rollback announced.**

21. The multilateral, rules-based system embodied in the WTO has proved its worth during this difficult period, curtailing the scope available to countries to increase protection. Major trading nations, OECD and non-OECD, have been fully cognisant of what is at stake and in most cases have refrained from using the full scope available legally under WTO to increase tariffs or to impose other barriers. But pressures will persist for some time, especially as spending is reduced from the very high levels of the stimulus efforts. To help governments to resist these pressures, and in order to maximise the role of trade in the recovery, the time is ripe to bring the DDA negotiations to a successful close. There is no better way to resist the on-going pressure than by locking in the important advances in opening markets that are within reach.

- **The DDA negotiations should be brought to a balanced and ambitious conclusion.**

22. There is a need for transparency concerning trade finance in order to ensure a level playing field. Almost by definition, support measures in this domain are implemented on a national basis, since their first objective is to continue to support domestic exporters. Undisciplined export-credit support measures may have discriminatory impacts, especially if they tend to become permanent. That is why vigilance is necessary and why monitoring should form an integral part of the policy response.

- **Export credit measures taken in response to the crisis should only remain in place until market conditions recover; they should be consistent with international obligations and be in line with sound underwriting principles.**

23. Should a decision be made to grant sector relief, the following “best practices” would reduce their trade-distorting effects

- **Only systemically important sectors should be aided (i.e. sectors essential to the overall functioning of the economy).**
- **Assistance should be time bound with a clear exit strategy and credible termination date.**
- **No conditions that interfere with commercial decisions should be included.**
- **No conditions explicitly favouring local or national suppliers or workers should be incorporated.**
- **There should be no discrimination between domestic and foreign-owned firms.**

24. Assistance to developing and other badly affected countries, including through Aid for Trade, should be maintained and strengthened. This is essential to ensure that less well-off countries, hard hit by the collapse in trade, do not suffer disproportionately and that they can emerge from the crisis with stronger growth and development prospects than would otherwise be possible. The Aid for Trade initiative is now, more than ever, essential to help suppliers from low-income countries build capacity and penetrate global markets.

The OECD Trade Committee: Next Steps

25. At the end of April the OECD Trade Committee agreed to undertake analysis of both the short and longer-term economic and trade effects of the full range of policy responses to the economic crisis. This work is just beginning; the present note has been prepared by the Secretariat and is an early and very preliminary report on work undertaken over the past few weeks.

26. The Trade Committee’s analytical efforts, which complement well the monitoring activity at the WTO, will continue over the coming year. As results are generated, discussions in the Trade Committee will take place with a view to identifying the characteristics of least trade distorting measures and ‘best

policy practices', to helping governments work together to minimise any negative effects of measures they might take and to develop a post-crisis policy framework that would help avoid disrupting international trade.

27. The Trade Committee is increasing efforts to communicate more aggressively, in order to increase public awareness of the dangers of protectionism and the benefits of opening markets further.