The International Economic Order in the Aftermath of the 'Great Recession': A Cautious Case for Optimism

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The Fear

Free traders should be frightened. Shouldn't they?

Over the last sixty-five years, the world has marched more or less steadily along the road of economic liberalization. Initially, tariffs fell with the post-war creation of the General Agreement on Tariffs and Trade. GATT was nimble, and GATT was quick, at least initially. After its creation in 1947, the GATT swiftly completed four rounds of negotiations by 1956, resulting in substantial drops of thousands of tariffs covering billions of world trade.[2] Over time, the GATT deepened into the World Trade Organization. The WTO polices not only the international exchange of goods, but also services and intellectual property; it covers tariffs and non-tariff barriers alike. International capital flows have grown tremendously as barriers to the international flow of money and credit have been steadily removed; they are almost completely gone in the rich North. And while free trade has deepened over the post-war period, it has simultaneously widened. A large number of developing countries have now embraced open markets, most notably in East Asia, and the former Soviet Bloc (remember the second world?). Although setbacks to the rise of globalization have (inevitably) occurred, these tend to have been small and transient (where are those G-7 protesters now?). The tide of history seemed to be carrying the international economic order ever closer towards free trade.

Until recently, that is. The "Great Recession" of 2007-9 has coincided – not accidentally – with what seems to be a startling reversal of these trends. Indeed, at first glance the international economic environment looks like it is headed towards a stunning reversal of globalization. And free traders are frightened. Very frightened. Respected institutions refer to "the protectionist

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[2] http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm

juggernaut" and "widespread harm done by discriminatory state measures."[3] Nobel laureate Paul Krugman has stated ""When it comes to international trade, actually it's not the Great Depression, it's worse."[4] And indeed, at first blush such words do not seem exaggerated. Consider just three pieces of evidence.

The International Economic Order: Three Reasons to Tremble

The first and perhaps most compelling reason why free-traders should worry is the utter collapse of international trade during the Great Recession. This decline in trade has been dubbed the "Great Synchronization" since it struck so many countries at approximately the same time.[5] Essentially all the rich countries experienced trade declines starting in mid/late 2008, as did a large number of developing countries. But the coincidence of this trade decline is less important than its magnitude. After years of substantial trade growth, trade started to fall sharply in October 2008, and continued through 2009; many countries recorded drops in trade of up to one-third by February 2009. This decline in trade is much the worst ever recorded since the Second World War. Some of the falls in trade are simply horrifying. For instance, Taiwan saw its exports fall over 40% in 2008; Singapore, Hong Kong and other East Asian countries have also been dramatically affected.[6] The dramatic slump of global trade is exhibit #1 in the catalogue of free trade worries.

The disintegration of trade may be the strongest cause for concern, but it is by no means the only. Free traders also shudder when they consider the large number of newly implemented protectionist policies. These have been spread across a host of countries; otherwise responsible rich nations have contributed at least their share. Perhaps the best single source to monitor this new protectionism is a web-based collaborative service *Global Trade Alert* administered by Simon Evenett of the University of St. Gallen and the CEPR. Some increase in the aggregate level of trade barriers was inevitable; protectionist pressures rise predictably as the economy declines. Still, the news from GTA seems horrifying to international economic liberals. Recent data from GTA indicate that a G-20 member has enacted a new protectionist measure at least *every three days* in 2009, despite their official statements to avoid protectionism. The measures do not generally take the visible form of tariffs or duties, and cover many sectors and jurisdictions. There are many offenders, though the US, China and

[3] Global Trade Alert (2009).

[4] http://blogs.wsj.com/economics/2009/10/07/paul-krugman-in-trade-its-not-the-great-depression-its-worse/

[5] http://www.voxeu.org/index.php?q=node/3751

[6] http://www.economist.com/businessfinance/displaystory.cfm?story_id=E1_TPQRDVPR

Indonesia are particularly egregious offenders.[7] Those who believe in a liberal international economic order instinctively recoil at such news.

A third and disturbing factor is the lack of leadership provided by the United States in the realm of international economic policy. Both during his campaign and in his early actions as president, Barack Obama has shown a singular lack of interest in defending free trade or combating protectionism. While the "Buy American" provisions in the stimulus package of February 2009 were watered down, no veto was threatened by the White House. America has failed to open its markets to Mexican trucking services, despite its NAFTA obligations. Two regional trade agreements with important American allies (Korea and Panama) languish without Senate ratification. In his first substantial action in international trade policy, President Obama imposed tariffs on Chinese tires in September 2009. Perhaps most importantly, the president has spent no political capital pushing for completion of the multilateral Doha round through the WTO. The United States has traditionally provided leadership in this sphere of international relations, so this absence is disturbing. But the United States is by no means the only country to blame. At Pittsburgh, the G-20 stated collectively "We will fight protectionism. We are committed to bringing the Doha Round to a successful conclusion in 2010. "[8]

All in all, the past year has seen an unprecedented collapse of trade and a surge in protectionism, neither of which has been countered by any serious attempt to return to the liberal trade regime. The summits have produced a string of empty communiqués which affirm the commitment to free trade, but these fine words have not been matched by deeds.

So yes, it seems that we should be frightened about the collapse of the liberal economic order. The free international exchange of goods, services or capital is a fragile man-made creation, and it appears to be under serious threat at present.

And Yet … Why Not to be Worried about the Great Synchronization

It seems like free traders have plenty of reason to worry about a retreat from globalization. But on closer inspection, more optimism seems warranted.

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[7] *Global Trade Alert* (http://www.globaltradealert.org/about) "*provides information in real time on state measures taken during the current global economic downturn that are likely to discriminate against foreign commerce. "* It is an independent organization, co-ordinated by the CEPR think-tank, which is intended to provide transparent, timely, and accessible content on potentially protectionist measures; this coverage is meant to be is comprehensive in terms of trading entities, sectors, and measures.

[8] http://www.G-20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf

Consider the primary reason to worry about the international economic order, the great synchronized decline in trade. There are in fact many reasons why trade collapsed, most of which have relatively benign interpretations. Trade always moves disproportionately with income. During good times, trade rises faster than output, as it has for most of the postwar period. But symmetrically, during bad times, trade falls by a multiple of the decline in GDP. Indeed, this multiplier seems to be rising over time.[9] Part of the reason for this is that trade and GDP are measured in different ways; trade is measured as gross flows, while GDP is measured as net value-added. More importantly, many goods are produced by combining a large number of small inputs that can be traded easily. As the value-chain becomes more fragmented across borders, trade has become more responsive to output. So the sharp decline in GDP which is the Great Recession has naturally resulted in a substantial drop in trade.

There are other reasons why trade shrank during 2008. The Great Recession was first and foremost a financial crisis; it struck a large number of key international banks. But these are precisely the institutions that provide the lifeblood of trade credit to the trading system. Also, compared with the economy as a whole, trade tends to be disproportionately composed of manufactured and capital goods. When physical investments and inventory sizes are reduced – as they were in late 2008 – the effect on international trade is then exaggerated. But symmetrically, as the banking system returns to health, investment resumes, and inventories fall below sustainable levels, trade can be expected to bounce back quickly.

Similarly, some of the fears concerning the rise of protectionism seem overblown. While any new protection is too much, it is striking that almost no one believes that protectionist policies *caused* the dramatic collapse of trade in late 2008. It is more plausible to think that the protectionism we see is the *result* of the Great Recession, rather than its cause.

Financial Protectionism: The Quiescent 800-pound Gorilla

For a free-trading economist, any protectionism is too much. But the amount of additional protection that we seem to be experiencing now seems remarkably low, at least so far. As a result of stimulus packages and bailouts in a variety of industries, governments control large chunks of the economy, and thus have ample opportunity to engage in protection. Yet they seem not to have taken advantage of these opportunities. The absence of any obvious "financial protectionism" is a particularly striking feature of the global landscape.

[9] http://www.voxeu.org/index.php?q=node/3731

In a number of the richest countries in the world, large banks have been nationalized *de facto* or *de jure*. One would imagine that governments would find it easy and politically popular to ensure that nationalized banks direct their credit disproportionately toward domestic interests at the expense of foreigners. Yet there is essentially no compelling evidence of financial protectionism as yet.[10] The word "protectionism" is not mentioned in the most recent (September 2009) *Quarterly Review* of the Bank for International Settlements. It receives only a single mention in the October 2009 *Global Financial Stability Report* of the International Monetary Fund.[11] Indeed, the latter publication does *not* indicate that state-sponsored measures have been discriminatory as one of the many "policy challenges" listed.[12]

So the march of international banking does not seem to have been notably disrupted thus far. And not only banking; other international capital flows have not been permanently affected by the Great Recession. After drying up in late 2008 and early 2009, international capital flows have recovered quickly; there is little evidence that domestic stock and bond markets have become more closed to international flows. Indeed, in the aggregate, global financial flows have not spiraled downwards as feared at the end of 2008 (or as experienced during the Great Depression of the 1930s). This recovery has not been experienced uniformly; international financial flows to Asia and Latin American seem to have resumed faster than those to emerging Europe. Still, emerging markets as a whole are still experiencing considerable capital flows. For instance, in 2008 the IMF indicates that emerging and developing economies received $724.3 billion in aggregate financial inflows (split between FDI, portfolio flows, reserve accumulation and other investments). While this does not match the 2006 pre-crisis level of $916.7 billion, it handily exceeds all years before 2006.[13,14] International trade of merchandise has also rebounded, but not so dramatically.[15]

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[10] GTA has 23 "measures" none of which is "financial"; see http://www.globaltradealert.org/measure.

[11] On p 163, where the report reads "Directors stressed that, in continuing policy interventions and planning for their withdrawal, as well as in designing regulatory reforms, international coordination will be vital to ensure a consistent approach and help avoid regulatory arbitrage, competitive distortions, and financial protectionism."

[12] Instead, the "policy challenges" discussed in the report are mostly focused on intertemporal aspects of handling expansionary monetary and fiscal policies that are unsustainable in the medium- and long-runs. The closest one gets to an international policy issue is on pxiii "And, fourth, international collaboration and coordination need to be improved to adequately cope with the challenges posed by cross-border institutions. Looking forward, to avoid a similar crisis, there is a need not just for better rules—through enhanced regulation—but also for adequate enforcement of the rules—through effective supervision— and for prudent behavior by financial institutions—through suitable internal risk management processes."

[13] Similarly, outflows are below 2006 and 2007 levels but exceed those from 2005 and earlier; see Table 1 (pp180-181) of IMF (2009). Further confirmation is provided in Table 14 which shows that the external financing of emerging markets from bonds, equity and loans ran at $125 billion in 2009Q2, slightly below the 2006 pace but above earlier rates.

There are a number of reasons for the relatively small buildup of protectionism. World leaders may truly believe in maintaining the liberal international economic order, and be forced to throw a small bone occasionally to abate protectionist interests. The efforts of institutions like the G-20 and *Global Trade Alert's* "name and shame" policy may have had some effect. It is particularly difficult to engage in protectionist practices throughout the European Union.[16] Plus there are a large number of newly-joined members of the EU who are unlikely to allow a return to closed markets. Indeed, a number of former communist counties are now in the vanguard of defending open markets. And perhaps most importantly, the response of the international financial institutions may have preserved the order which they were created to defend.

The Response of the International Institutions

The IMF is the lead international agency tasked with handling financial crises. The Fund received considerable support from the political community through the crisis, and its role in supporting the international economic order – as chief firefighter – has been affirmed. The IMF won extra resources in the form of a new SDR allocation of $250 billion. Further, its total lending capacity has been tripled (through an expansion of the *New Arrangements to Borrow*) so that $750 billion is now available.[17] In the area of international crisis management (as opposed to international trade liberalization), the world leaders have backed their words with actions.

For the most part, the IMF has risen to the occasion. The Fund has used its resources forcefully and mostly to good effect; there is none of the backlash that characterized the anti-IMF attitudes after the Asian crisis. It created a new facility in the *Flexible Credit Line* which provides funds to pre-approved countries without conditionality; Poland, Mexico and Colombia have taken advantage of this facility.[18] The Fund has also put into place over a dozen more conventional arrangements, mostly in Central/Eastern Europe and the former Soviet bloc. It has moved quickly and decisively to replace the sudden stop in capital inflows with large

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[14] Indeed, the BIS notes that the international banking system has maintained its exposure to emerging markets since 2008, once currency valuation effects have been taken into account (BIS 2009, p21).

[15] http://www.wto.org/english/res_e/statis_e/quarterly_world_exp_e.htm

[16] The European Commission has issued guidelines to limit crisis-linked aid to financial institutions to the necessary minimum, and instituted safeguards to ensure against distortions to competition; see http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/446&format=HTML&aged=0&language=EN&guiLanguage=en.

[17] http://www.imf.org/external/np/exr/facts/changing.htm

[18] http://www.londonsummit.gov.uk/en/summit-aims/summit-communique/

programs.[19] These have been better received than previous IMF programs, and seem to have largely achieved their goals; dramatic exchange rate overshootings have been rare during the crisis of 2008. As of October 31 2009, the IMF had provided arrangements that total a record $225 billion, although only a fifth of this had actually been drawn.[20] By way of contrast, the IMF committed $36 billion to Indonesia, Korea, and Thailand during the Asian crisis.[21] Still, given its expansion, the size of unused IMF resources remains large, both absolutely and compared to previous crisis episodes. The Fund is well placed to underwrite the continuing recovery of the international economy.

Part of the reason why the disposable resources of the IMF remain large is reluctance on the part of a number of countries to take advantage of loans from the Fund. This is especially true in East Asia where the conditions associated with the "Asian Crisis" packages of 1997-98 were widely viewed as having been excessively stringent. Accordingly, these countries and territories accumulated large "war chests" of international reserves after 1997 to avoid having to return to the IMF for loans. And the war chests are large; above and beyond China and Japan, Taiwan, Korea, Hong Kong, Singapore, and Thailand each have international reserves above $100 billion.[22] But these are also precisely the countries that seem to have benefited most from openness and international commerce. It seems hard to believe that the massive and growing web of intra-regional Asian trade will be destroyed through some collective suicidal tendency.

Where the interwar period offered the rigor and deflation of the gold standard, we now have a new improved IMF. And even this understates the development in the institutional fabric of the international economy, since the *Financial Stability Forum* has emerged as a potentially strong new player, established "to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability."[23] While the FSF is only a nascent development, it has already been described by the American Treasury Secretary as the new fourth "Bretton Woods" institution (along with the WTO, the IMF, and the World Bank).[24] The empty promises concerning international cooperation have occurred only on the international trade front.

[19] Indeed, as noted above, the sudden stop of capital flows that began in late 2008 is quickly becoming a thing of the past, in part because of the Fund's actions.

[20] http://www.imf.org/external/np/pp/eng/2009/091409.pdf

[21] http://www.imf.org/external/np/exr/facts/asia.pdf

[22] https://www.cia.gov/library/publications/the-world-factbook/rankorder/2188rank.html?countryCode=as&rankAnchorRow=#as

[23] http://www.financialstabilityboard.org/

[24] Geithner, Timothy (2009) "Geithner: 'L'era del controllo globale'," *Il Sole 24 Ore*, 6 October, p.7

Bullets Dodged

The period since the onset of the Great Recession has seen large changes in economic policy. A number of countries have loosened fiscal policy to support domestic demand, or rescued large financial institutions with systemic externalities (or both). The loosening of monetary policy has been even more dramatic; interest rates have been slashed essentially to zero in the United States, the Eurozone, Japan, the UK, Canada, Switzerland, Hong Kong, Korea, and a host of other countries. However, there have been remarkably few changes in monetary *regimes*, a fact that stands in stark contrast to previous crises. During the Great Recession, no country has dropped out of a monetary union, a tightly fixed exchange rate peg, or an inflation targeting regime. Accordingly, exchange rate policy has remained unchanged for the vast majority of countries.[25]

The durability of exchange rate policy during a crisis of the magnitude of the Great Recession is striking. Many governments must have been tempted to pursue "beggar thy neighbor" currency depreciations, improving the competitiveness of their exports at the expense of others. That's especially true since one country – Switzerland, of all places – actually has pursued such monetary policy of late.[26] Yet the Swiss intervention does not appear to have provoked any substantial replication or retaliation.[27] This is curious, given that more extreme versions of the policy has been advocated by serious academics with policy credibility.[28]

Indeed, not only have exchange rate regimes remained essentially unchanged through the crisis; some key exchange rates seem to have changed remarkably little. This is in spite of the dramatic loosening of monetary and fiscal policies, which have varied in timing and magnitude across countries. In July 2007, immediately before the beginning of the turmoil in financial markets, the Federal Reserve Board's broad nominal exchange rate index was 102.8; as of the writing of this paper in November 2009, it stands at 102.0 (the broad real index declined slightly

[25] There have been a few minor adjustments in places like Ukraine and Belarus, primarily making exchange rate policy somewhat more flexible.

[26] In its "Monetary Policy Assessement" of March 12, 2009, the Swiss National bank stated that it was "making another interest rate cut and acting to prevent any further appreciation
of the Swiss franc against the euro. To this end, it will increase liquidity substantially by
engaging in additional repo operations, buying Swiss franc bonds issued by private sector borrowers and purchasing foreign currency on the foreign exchange markets." This was widely and immediately interpreted as a beggar-thy-neighbor depreciation to counter the rapid appreciation of the Swiss franc.

[27] As of Nove 10, 2009, GTA records only 2 measures under "Competitive Devaluation" measures: Kazakhstan's 25% devaluation, and state aid to state-owned Indonesian sugar firms (?).

[28] Lars Svensson, a distinguished economist from Princeton and Stockholm who is currently a deputy governor of the Swedish Riksbank incorporates currency depreciation as part of his "foolproof method" for handling Japan's Liquidity Trap.

from 92.1 to 85.8).[29] The most important bilateral exchange rate is the dollar/euro rate. Immediately before the crisis broke out in August 2007, this rate was $1.36/euro. On Jan 1 2008 it stood at $1.47, and ended 2008 at $1.39; in November 2009, the rate stands at $1.48 to the euro.[30] Obviously there have been fluctuations in the interim; floating exchange rates are notoriously volatile. Still, one could reasonably have expected more major exchange rate volatility in the face of the extreme stock and bond market volatility that appeared during the Great Recession.

No News is Good News

The Great Recession has not precipitated any sovereign defaults, with the one exception of Iceland. Throughout the period, the Paris Club has continued to process debt renegotiations with a number of countries, but none of them seriously affected by the financial crisis.[31] Also, few capital or exchange control restrictions have been created. Iceland is again the outlier, having imposed controls in late 2008 after the devastating collapse of the Icelandic currency. Still, it has already begun to lift these barriers.[32]

Unlike the Great Depression, there have been no failed economic conferences. There is an enormous contrast between the failed London economic conference of 1933 and the G-20 London conference of 2009. Indeed, the current crisis has seen the empowerment of a substantively new economic group – the G-20 – at the expense of the G-8. While the G-20 was technically created in 1999, it achieved prominence during the Great Recession, especially with the Washington Summit of mid-November 2008. While G-20 summits may be mostly show, at least they have replaced unilateral actions that might otherwise been expected such as the "Nixon Shock" of August 1971 which ended the Bretton Woods regime.[33]

[29] http://www.federalreserve.gov/releases/H10/Summary/indexb_m.txt Similarly, the Euro's nominal effective exchange rate index has moved from 107.5 in July 2007 to 116.8 in November 2009.

[30] Clearly not all exchange rates exhibited such stability. Minor currencies (like the Icelandic kronor) collapsed, while some more important currencies appreciated, most importantly the Japanese yen.

[31] Paris Club *2008 Annual Report*, http://www.clubdeparis.org/sections/communication/communiques/publication-du-rapport/downloadFile/attachment1_file/Annual_Report_2008.pdf?nocache=1245863975.94. The Paris Club concluded agreements in 2008 with Djibouti, Congo Gambia, Guinea, Liberia, and Togo. 2009 has been little different, with Paris Club treatments of Burundi, CAR, Cote d'Ivoire, Haiti, Seychelles, and Togo; see http://www.clubdeparis.org/sections/communication/communiques

[32] While barriers to capital flows have been imposed by Brazil recently, these are controls on inflows, not outflows.

[33] http://en.wikipedia.org/wiki/Nixon_Shock

Conclusion

It is easy to become depressed about the world economy. While a number of economies seem to have entered the early stages of recovery, growth everywhere now seems low, fragile, and jobless. The international trading system has suffered a tremendous shock, and protectionism is on the rise. Yet it is easy and mistaken to overlook the good news, especially since most of it consists in bullets dodged.

The international economic order seems to have withstood the most dramatic economic shocks experienced since the 1930s, and it currently remains in working order. There has been a regrettable increase in protectionism, but so far it has been slight, certainly compared with what could have been imagined. After a horrifying plunge in late 2008, goods and capital are again flowing across international borders. The global economy has turned back from the brink.

Global crises sometimes strengthen international cooperation. The Second World War is a case in point; the United Nations, the GATT, the IMF, the World Bank, and a host of other institutions were created in the aftermath of the bloodshed and chaos of the greatest conflict ever experienced by man. But not all global crises have had this effect; the First World War and the Great Depression both seemed to create environments which essentially disrupted the peaceful international exchange of ideas, goods, and capital. Thus far, the "Great Recession" of 2007-9 seems to be more like the benign former type than the latter. One hopes that this impression will be confirmed in a decade's time.

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