

Trade Openness Is Now More Important Than Ever

BY ANNE O. KRUEGER

IN THE MIDST OF THE SEVERE CURRENT RECESSION, it is easy to forget that the international economy has experienced unprecedented growth over the past sixty years. Despite the present downturn, living standards in almost every country are higher than they have ever been; life expectancy is at an all time high, the growth rate of world real GDP has been higher on average than in any period in economic history, and some countries have adopted policies that have enabled them to grow at spectacular and unheard of rates.

Successes of trade liberalization

A MAJOR FACTOR contributing to the successes of the past sixty years has been the liberalization of international trade. At the end of World War II, tariffs were high and nontariff barriers proliferated. Through successive rounds of trade negotiations under the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), the average level of tariffs on manufactures in industrial countries fell from 45-50 percent in 1948 to an average of about 3 percent



A tire shop in Beijing, China lodged a complaint with WTO over tariffs imposed by Washington on its tire products.

today. Over the same period, quantitative restrictions on imports were almost entirely dismantled, and many other barriers to trade were reduced or eliminated. While work still remains to be done, international trade in the first decade of the 21st century has been freer than at any time in world history. It is no accident that increased integration, "globalization," in trading ties was accompanied by spectacularly successful economic growth.

The world economy was in a virtuous circle: trade liberalization spurred economic growth, which in turn, made it easier for politicians to take measures for further trade liberalization. The process was facilitated by falling transport and communications costs.

Of course, a great deal remains to be achieved to improve material well-being even after recovery from this recession. Poverty will still afflict many people, some countries' living standards will have advanced only slowly, and other challenges will also persist. To address these issues, the robust growth rates that characterized the past sixty years will have to resume.

Need for further trade liberalization

BUT RECOVERY FROM THE RECESSION and resuming those growth rates will both require further liberalization of trade in goods and services in the international economy and would be retarded, if not prevented, by backsliding. Consider the benefits and opportunities that liberalized trade provides. For all countries, liberalized trade creates an economic environment in which there can be more competition than in a closed economy, and one in which domestic producers are exposed to international best practice. Either of these benefits alone raises productivity in countries with open trading regimes; imports are as beneficial in this regard as exports. Monopolists, and even comfortable oligopolists, generally produce low-quality items at high cost in their protected mar-



The Keppel container port terminal in Singapore. The nation's main exports fell at a slower pace in 2009.

kets, and make little effort to learn about best practices in other countries.

Moreover, for most poor countries, where comparative advantage lies in abundant unskilled labor, an open economy with a realistic exchange rate provides incentives for growth of export industries which can compete in international markets and employ workers. In the process, workers gain skills and, as growth continues, producers can move "up the value added chain." This strategy has enabled the rapid growth of East Asian and other countries; no country has maintained satisfactory growth through inward-oriented development policies.

The rapid expansion of trade (and falling transportation and communication costs) has enabled a "chopping up" of the value added chain as different parts and components are produced in countries where costs are lowest. This integration of production across national boundaries has resulted in major productivity gains and accelerated growth, but has also made any erection of trade barriers far more costly than in the past.

A final advantage is that an open economy greatly reduces the ability of individual producing interests to influence politicians to grant them special favors. The international market is objective and performance in that market provides feedback to economic policy makers. By contrast, there is little basis on which to evaluate the performance of domestic monopolists, protected by high tariff barriers or import licensing requirements.

The threat of protectionism

PROTECTION NOW CONSTITUTES a double threat. It can make recovery from the recession slower than it would otherwise be. But it can also greatly reduce the growth potential of the international economy once recovery has taken hold, and especially harm the low-income countries by eliminating the opportunities for more rapid growth that outer-oriented trade strategies provide.

The current threat arises because protectionist sentiments increase during recessions, along with greater pressures on politicians to heed them. However, once a protectionist measure has been taken by a country or countries, others retaliate. This has already happened to some degree in the current recession. For example, once America provided support for its automobile industry, Canada, Japan, and some European countries took similar measures to protect their own auto industries. This results in overcapacity in the industry, with sizeable costs to taxpayers and a failure of the global industry to restructure in an economically efficient way. The value of WTO rules was demonstrated earlier this year when a proposal in the American Congress to insist on a "Buy American" clause in the stimulus package was amended, under pressure, to insure consistency with the government procurement agreement negotiated under the WTO. China, not a signatory to the WTO agreement, was not so constrained.

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and Malaysia are mainly a way of signaling its global ambitions. These countries cannot use renminbi to intervene in foreign exchange markets. They cannot use it to import merchandise from third countries or to pay foreign banks and bondholders.

In time, China can strengthen the international role of the renminbi by developing liquid financial markets and liberalizing foreigners' access to these markets. Over time, it can also make its currency convertible for financial as well as merchandise transactions. The question is: how *much* time? Reconciling financial stability with capital account convertibility has formidable prerequisites. Markets must first become more transparent. Banks must be commercialized. Supervision and regulation must be strengthened, and the exchange rate must be made more flexible to accommodate a larger volume of capital flows.

China, in other words, must first move away from a growth model in which bank lending and a pegged currency have been two of the pillars of its development policy. This is easier said than done. Witness how the Chinese authorities' reaction to the crisis was in fact to move in the other direction, relying more on directed lending to boost investment and hardening the renminbi's peg to the dollar to sustain exports.

The year 2020 is the authorities' target date for transforming Shanghai into an international financial center and thus, de facto, for the capital account convertibility that is a prerequisite for a reserve-currency role for the renminbi. But even if China grows at a 7 percent annual rate for the next decade (slower than in the past, reflecting less favorable demographics, but still exceptional), its GDP in 2020 will still be considerably smaller than that of the U.S. at market exchange rates. The renminbi will still have a smaller domestic platform than the dollar. In turn this means that its market liquidity will not be comparable.

Under these circumstances, the attractiveness of holding reserves in renminbi will be limited. It will be most attractive to countries conducting the majority of their trade with China and doing their international financial business in Shanghai. This suggests that the market for renminbi reserves will, at least initially, be concentrated in Asia, much as the market for euro reserves is concentrated in Europe.

The resilient dollar

I CONCLUDE, BY PROCESS OF ELIMINATION, that the dollar will remain the principal form of international reserves for the foreseeable future. It will not be as dominant as in the past, for the same reasons that the United States will not be as dominant economically as in the past. In the short run the euro will continue to gain market share, especially in Greater Europe. In the longer run there will be a role for the renminbi, especially in Greater Asia. But as far into the future as I personally am able to see, the dollar will remain first among equals. 🐾

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When countries try to protect their own industries, any short-run gains in a given industry are generally offset by losses in others; and industries using imports of the protected goods either face higher costs of production or must develop higher-cost domestic supply sources). The global economy is worse off as a result of reduced productivity and output. This happened in the 1930s, when the Smoot-Hawley tariff passed by the American Congress erected high tariff barriers in the United States. Other countries retaliated and international trade shrank by an even greater proportion than world GDP during the Great Depression. Economic historians blame the high tariff barriers that were erected in the U.S. and elsewhere as being a major contributing factor to the length and severity of the Great Depression. Because of the increased integration of the world economy, the costs of protection today would be even greater than they were in the 1930s.

Politically it is relatively easy to erect protective barriers, but difficult to remove them. World output will be lower and the recession somewhat deeper if countries become more protectionist. But the real question is how soon and how rapid the upturn and the return to global economic growth will be. And it is here that the dangers of protection are worst: if exporters everywhere are confronted with trade barriers, they will not invest in additional capacity to the same extent as they would in a more open global system, and resources will remain stuck in industries (such as autos and steel) where excess capacity exists and there is little incentive for further investment.

In such a post-recession world, poor countries' prospects for growth through an outer-oriented trade strategy would still be better than if they were to adopt protectionist barriers, but less favorable than if the world returned to an open, liberal, multilateral trading system.

Policy makers' concerns about the short run and the temptation of protectionism are understandable. But protectionism will invite retaliation and, once started, will increase pressures and temptations for even more protectionism.

Policy makers can reduce the threat by reviving and completing the Doha Round of multilateral trade negotiations under the WTO. Such an action would strengthen the open multilateral trading system, serve as a barrier against further protection (especially by reassuring those who argue for protection because "others will do it"), and provide producers with appropriate signals that it is safe to invest in export industries because they will still be operating on level playing fields. 🐾

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