

**Transcript of Remarks by Richard Baldwin
At a Meeting hosted by BERR
London, 18 December 2008**

Richard Baldwin:

I'd like to thank BERR for hosting this meeting. It is a pleasure to be back here at the BERR to talk about CEPR's policy research.

Today I want to talk about trade and the global economic crisis. When CEPR and BERR scheduled this meeting, it was to be a launch for the Ebook on trade edited by Simon Evenett and myself. But as Ken Warwick said the world has changed. This is a crisis where the impossible happens every month and the improbable twice a week. Since this book was produced, several improbable things have happened and maybe one impossible thing.

In my comments, I'm going to do three things. I'm going to talk a little bit about the e-book. Then I'm going to make an attempt at raising your anxiety levels about the importance of trade in this crisis. Then I want to talk about "Plan B", which is what we should do about it. When I say "we" I mean the UK Government as the Chair of the G20 and my goal is to convince you that the G20 agenda should be directed more towards doing something on trade than was the G20's 15 November 2008 summit. I think there's a great urgency for the G20 to be seen as doing something on trade. They need to do something, because the G20 is all about confidence. And the only concrete thing they committed to with a date was Doha modalities, and they missed it, but without too much difficulty, they can get something else to prove that the G20 is not just a vacuous photo opportunity.

The book, entitled "What world leaders should do to halt the spread of protectionism" was edited by myself and Simon Evenett, who unfortunately couldn't be here today. We started this project on the 24th of November, when we invited 17 scholars from around the G20 to submit thousand word essays on the question which is the title of the book. They wrote those for the deadline of December 1st, and we had the thing posted midday on December 4th, after editing it. This sounds like a quick turn around but it was actually three times slower than the first Ebook, so it was much easier.

Simon and I started thinking about an e-book on protectionism about the same time Barry Eichengreen and I did the G20 e-book in mid-November. Although Simon and I were both convinced that there was something huge happening very quickly on trade, we weren't convinced that the world was ready to hear about it. When this book first came out on the 4th of December, many people thought that it was over the top, that the idea of spreading protectionism was exaggerated. As we heard from the two introductory speakers, and you read the newspaper every day, trade volumes are collapsing. Monthly trade data show it collapsing at an alarming rate. Japanese and Chinese exports have fallen. Trade barriers are rising. There's

quite a number of cases documented now. I don't have time to go through the data, but I would be very happy to show you some data I have if it comes up in the discussion. I think this is happening with an alarming speed, and that is what is a little bit worrying about it.

OK. Let me just read you the list of authors, the ones who did the work. It was Ann Capling from Australian National University, Wendy Dobson from Toronto, Peter Draper from Johannesburg, Jeff Schott and Gary Hufbauer from Washington, Doug Irwin from Dartmouth, Patrick here from Paris, R.V. Kanoria, who's the President of ICC in India, Bob Lawrence from Harvard, Kevin O'Rourke from Dublin, Yung Chul Park from Seoul National University, Hadi Soesastro from Jakarta, and Ryuhei Wakasugi from Kyoto.

So, you can see this is not the narrow Northern Atlantic crowd, they are from across the G20. And almost everybody had the same answer, though they varied a bit. The three points of consensus were: one, use macro measures not trade measures to address the crisis, and I think that was one thing that was taken at heart, although the substitutability was not clear; two, wrap up the Doha modalities, and if you don't know what modalities are I just have to apologise; I don't have time to explain it, and you probably wouldn't be interested; and three, to establish a WTO/IMF surveillance mechanism to keep track of the protectionism that we are seeing, and will see, and I think we'll see at an accelerating pace.

Now, in the usual world – the world we thought we knew before Lehman's collapse – a book that was posted on the Internet on December 4th and launched at the WTO on December 10th, would be fresh; it would be news. When I come to London on the 18th of December, I'd be trying to convince you to read it and that it was relevant. But that's not the world we live in. Events have accelerated and the old way of doing policy analysis has been antiquated. We live in a world where a book written for a 1 December deadline can be out of date on 18 December. In fact, the world has changed since the book was posted on the 4th, the world has changed since the book was launched at the WTO on the 10th, and in fact it has changed since yesterday.

So, what I would like to do is spend a few moments trying to raise your anxiety level about how this crisis can move into the world of trade. As Richard Portes said, it's been a mostly macro / finance thing to this point, but I think it's about to make a very bold entry into the world of trade.

First of all, as many of you have been reading in the paper, the crisis is coming to the emerging markets via the trade accounts, mainly manufacturing, and to the developing countries via commodity prices and a general slowdown. This is quite different than other crises. It's not coming through the capital account and loss of confidence in lending and borrowing. It's coming through the trade account.

I want to go through a series of four facts and then sort of weave them together in an amorphous way, which will hopefully make you think that trade is more important in this crisis than you thought.

So, fact one is this is not a standard Keynesian trade shock for emerging markets, a fact that many people haven't quite realized. In the Keynesian world, my exports depend upon your GDP and my imports depend upon my GDP. So, the emerging markets should experience a trade shock when the US, EU, and Japan go into recession. The emerging markets can't sell what they used to, yet they continue importing so they get an imbalance in their trade account with this leading to falling aggregate demand. That's the standard Keynesian trade shock story you all know.

That's not what's happening. The world now, especially East Asia, is something like one great big factory. I like to call it "Factory Asia". As production has been unbundled and spread around the world, nobody makes stuff any more. They make bits and pieces and ship them on somewhere else to put them together. When the crisis pushed the rich countries into a recession, the factory's customers stopped buying. That shuts down the whole factory, all the conveyor belts. So one should expect, if one knows how the world trade is today, the new century world of trade, that we should see a rapid fall of imports and exports more or less simultaneously, with the effect concentrated in manufacturing. That's what we're seeing on a month-by-month basis. I don't have time to show the slide--I have a few later on--but if you look at the monthly data, which is available for all the G20 countries up to September, lots of them are down. If you look at October and November, many of them are down quite sharply. This is happening in a very rapid way.

The second point is there is a multiplier effect on demand and trade. It's not like in the old days, because, if you remember, as trade went up, each final good more or less got traded two or three times. So as demand, final sales in the US and the EU went up by one dollar it would generate 1.5 dollars of trade in East Asia. It's working in reverse now, so we will see a radical, and rapid, fall in trade, much more rapid than one would anticipate in the standard econometric models.

The third point to stress on this is, because it's not a standard Keynesian model, it's going to be very sector-specific. We've seen this already, although I haven't got the figures. It will hit jobs in the manufacturing sector. Not a general slowdown, not across the economy, but one sector will start shutting down, and very rapidly, all through the emerging markets.

Because it's sector-specific, the macro stimulus doesn't work very well. To put it in colloquial terms, if we don't buy all those cheap electronics, plastic toys, and tee shirts, no amount of Chinese fiscal stimulus is going to get the Chinese to buy them. So, what you will have is a sector-specific recession, which will be very difficult to get rid of through macro tools.

Second fact: many of these countries are riding the tiger. As Winston Churchill said, "Dictators ride the tiger to and fro, and dare not get off, because the tiger is getting hungry". I think that sort of sums it up. One of the major sources of my anxiety is that – take China, Vietnam, a number of these countries – the heart and soul of the social contract is growing manufacturing employment. All the tension between the urban and rural, the rich and the poor, the dictators

and the people, it's all based on the fact that employment in manufacturing is growing at eight to 10 percent per year, and is expected to do so forever. When that deal stops, the tiger may eat his rider, and this happened in '97, by the way. Indonesia's dictator got thrown out, and, to a certain extent, the Korean leadership got shuffled around by political forces linked to the crisis.

What that means is that the emerging markets cannot sit still. They can't ride this out, especially the ones who are riding the fiercest tigers. They will have to do something to stimulate exports. I think that's one of the things we are going to see going forward: a great big round of competitive devaluations, even by countries that are running trade surpluses. They are also cutting export taxes, allowing export rebates. You can do it in clever ways with this factory. By cutting the tariff on imported components, you can actually subsidize domestic production of final goods or components further down the value-added chain. So there are many clever ways you can do it, and they're going to do them all, and they're going to do it very rapidly, or perhaps face social unrest. This is the first part of my nightmare scenario.

Fact Three: The US Congress is protectionist, and in no mood to put up with mercantilist moves by China, and East Asia in general. So, the possibility of an "echo chamber" getting going is very real. We're not in a world where the US is in relatively good times as it was in the last global crisis of 1997 when the US was feeling relatively magnanimous. The US Congress is angry, especially about the Chinese exchange rate, and there are several bills before Congress which would commit the US to quasi-WTO-legal or maybe actually illegal actions, which could pass, if they got angry enough.

Fact Four: The anger is not one-sided. Many people around the world are very angry at America and, maybe the UK by association, for having caused this crisis. So when China says to themselves "Are we justified in doing things like subsidizing exports, to defend ourselves against the crisis that came from the US" they will feel morally justified. What you will have is two groups of people who are doing things and very angry at each other. An echo chamber where protectionist moves get met with more protectionist moves.

This is my nightmare scenario, of an echo chamber where competitive devaluations and quasi-GATT-legal or GATT-illegal things are done to maintain jobs in the manufacturing sector in the emerging markets, and that causes a protectionist backlash in the US Congress, perhaps followed by other countries.

Let's hope all this stays in the dream world.

But even if the nightmare doesn't happen, it is very clear that we're looking at a trade system under stress for at least a year. Great stress! This will ruin the atmospherics, I think, for trade talks, and also climate talks and many other things. I think that this deterioration of the trade system is something that we should take very, very seriously. Second, temporary protection often turns into permanent protection. So there's a possibility that the protectionist implications of this crisis will go further. I have some data on how much

protection there is, or how much there could be. There is a bit of a debate going on. We don't know yet. We can talk about the numbers in the discussion.

Lastly, the G20 is largely about confidence building. They failed on modalities, so they need to do something else. So it's time for Plan B.

So our Plan B, this came from last week's Vox column, and we – that is Simon and I – were stressing that there should be an “early harvest” of something, anything, really. The thing we could think of first was trade facilitation, and it has a number of interesting elements. Simon follows this very, very closely. For one thing, there's something for everybody. The rich country manufacturers are the ones doing this fragmentation and outsourcing, so when trade is easier, they gain. The emerging markets like it, because it helps them industrialize, and the poor countries usually get some sort of technical assistance or aid out of it. So it's one of these package deals, which would make everybody happy as long as the rich countries are willing to pony up some money for the trade for aid, it could work. Even talking about it would be useful.

The second thing would be to implement a monitoring and surveillance mechanism, perhaps WTO, IMF, ITC, maybe just the WTO – it could go a variety of ways.

Third, and most innovatively – and in this context ‘innovate’ means we can't do it in time – would be to modernize the BOP Clause of the WTO. I don't know how well you know the WTO or the GATT, but there's a clause in there, which was from the gold standard, that if you have a balance of payments crisis, you can do just about anything you want. It's a safeguard. When you get a balance of payments crisis, you can put up import protections, tax exports, etc. You can do just about anything, and India did for a long time. It was put in there for a reason, and now it's sort of outdated. Maybe we should modernize that, and have a crisis safeguard for the next crisis.

So, we wrote that Vox column last week. In a normal world, I'd be trying to convince you that what we said was right or at least relevant. But the world has changed. And as I said, in this crisis, the impossible happens monthly, and the improbable happens twice a week. The improbable happened yesterday when Lamy suggested a Plan B, that includes two of our three elements. This was the outcome of yesterday's Trade Negotiations Committee, and I'm quoting from the Trade Press Release.

“DG Pascal Lamy told the Trade Negotiations Committee on 17 December 2008 that ‘Concluding the Round should remain our focus in 2009, but this endeavour takes place within a more global portfolio of WTO activities.’ ”

When we launched this last week at the WTO building, Simon put it this way: “The WTO has to learn to walk and chew gum at the same time.” Lamy didn't embrace that language, for some reason or another. He proposed a broader

front, such as monitoring trade measures taken in relation to the crisis, doing trade finance, and aid for trade.

So I'll skip the conclusion I've said several times.

Basically, I think the message is that the G20 now has something to work on. Lamy has concrete proposals in front of the world audience that need political support from the G20 leaders, and this is where you can make a difference.

OK. So I'll end here.