Centre for European Reform

Another Great Depression?

by Katinka Barysch, 15 October 2008

Many observers have drawn parallels between the current economic crisis and the Great Depression of the 1930s. However, the stock market collapse of 1929 did not directly cause what turned out to be the deepest and most prolonged recession of modern times, ultimately ending in the Second World War. The blame lies with misguided macro-economic policies and protectionist reactions, such as the infamous Smoot-Hawley tariff of June 1930, which contributed to a collapse in international trade. The downturn that is now hitting the US and EU economies will fuel protectionist reflexes. But unless western countries are prepared to tear up the rulebook of the World Trade Organisation, their room for manoeuvre is in fact limited.

Trade flows will of course be affected by the current crisis: domestic demand in the US, UK and other big economies is falling, companies cannot get the credit needed to finance exports and imports, and high energy prices have been pushing up shipping costs (although pressures are abating as oil prices fall). The Economist Intelligence Unit predicts that world trade will grow by only 4-5 per cent next year. That is a lot less than the average of 8 per cent recorded in the previous five years. But it is nothing compared with the Great Depression when real world trade flows contracted by around 14 per cent.

Surveys show that support for free trade among Europeans has been in decline for a couple of years, as people have become more concerned about globalisation, and in particular the rise of China. But overall, Europeans still hold rather benign views on international trade: over 80 per cent of Germans, French, Italians, Poles and Spaniards think that growing trade ties are, on balance, good for their country. Remarkably, in the traditionally more liberal UK the share is lower, at 77 per cent, and in the US barely over half, according to a Pew Global Attitudes Survey published earlier this year.

With many EU economies descending into recession and unemployment rising, enthusiasm for foreign trade will of course diminish. People fearing for their jobs and incomes are often happy to blame outside competition. The worry is that protectionist voices are growing louder around the world at a time when the multilateral trading system is severely weakened by the collapse of the Doha trade talks in July. However, while there is little chance of Doha - or any other ambitious trade deals - being concluded before economic conditions improve, the risk of a full-scale protectionist backlash appears small.

Most European countries trade more with their EU neighbours than with the rest of the world. Intra-EU trade is governed by the strict rules of the *acquis*, which does not allow any tariff or non-tariff barriers. The current recession will weaken EU countries' commitment to state-aid rules, competition policy, as well as the liberalisation of services sectors and network industries such as energy. But the economic downturn would have to become truly catastrophic for trade barriers to re-appear within the EU.

The EU's hands are also bound when it comes to trade with the outside world. Since the Great Depression, the world's trading powers have conducted eight rounds of multilateral trade negotiations. As a result, tariffs on almost all manufacturing imports into the EU are low. And there are strict rules governing the use of 'safeguard' measures (to guard against surges in imports) and anti-dumping and anti-subsidy duties (to punish overseas producers that sell at artificially low prices). The EU could of course stretch, bend or even breach these rules to give temporary reprieve to, say, car companies, steel makers or clothing manufacturers (until a WTO court ruling resolves the issue). But such actions would probably only affect EU trade at the margins.

The failure of the Doha round does not substantially alter the trade regime of developed countries. However, unlike in the EU (and the US and Japan), developing countries are applying tariffs that are a lot lower (in some cases 20-30 per cent) than what they legally agreed to in previous trade rounds. Countries such as Mexico, India, South Africa or Korea could ramp up their tariff protection without breaching WTO rules. European politicians, and the Commission, could then come under pressure to retaliate. Moreover, a heavily Democrat-controlled US Congress could be a lot more hawkish on international trade. The main risk then is not that the rich countries will abandon their WTO commitments on a grand scale. It is that angry exchanges about economics poison the political atmosphere and make it more difficult for countries to work together on other issues, such as climate change.

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