



IS PROTECTIONISM DYING?

**Uri Dadush, Shimelse Ali,
and Rachel Esplin Odell**

INTERNATIONAL ECONOMICS | MAY 2011

CARNEGIE ENDOWMENT

FOR INTERNATIONAL PEACE

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Summary

Despite a limited increase in the incidence of protectionist measures during the recent financial and economic crisis, the effects on global trade appear small—the world, remarkably, did not resort to protectionism. In addition to the concerted stimulus measures, financial rescues, and the strengthening of lender-of-last-resort facilities that restricted the duration and depth of the economic downturn, the World Trade Organization’s disciplines, enforceable through its dispute settlement mechanism, no doubt played an important role in staving off trade protection.

But this is only one part of the story. The increased resistance to protectionism is the result of a complex, mutually reinforcing set of legal and structural changes in the world economy that have made a return to protection more costly and disruptive and have established new vested interests in open markets. These changes include:

- **National disciplines:** Along with autonomous liberalization and a generally robust rule of law in the largest trading countries—which improve the confidence of importers and exporters—national trade tribunals help prevent protectionism by providing a mechanism whereby individual firms can contest protectionist measures that impact their company. Many national governments have also developed explicit or implicit mechanisms for countering protectionism and ensuring that trade policy reflects the general interest.
- **Regional and bilateral agreements:** In addition to codifying further tariff reductions, regional trade agreements—now covering over half of world trade—contain provisions establishing dispute settlement mechanisms that parties can use to contest violations of the agreement and thereby defend against protectionism. Furthermore, such agreements have often established regular high-level dialogues on trade disputes, treaty implementation, and further liberalization, providing a mechanism for resolving serious violations of the agreement even if its formal juridical mechanisms are not utilized.
- **“Facts on the ground”:** The political resistance to backsliding on liberalization is stronger because trade has become more prevalent and inextricably

woven into production and consumption patterns. The change in the political economy of protectionism is manifested in the increased interest of retailers and consumers in imports, the internationalization of production, and the rise of intrafirm trade. Limiting trade in any one sector not only hurts those consumers, retailers, and firms that depend on imports for inputs, but also has repercussions for firms that operate both vertically (within a sector) and horizontally (across sectors) that depend on complex global production chains.

In addition to good macroeconomic and social policies that limit the impact of economic downturns, ensuring an open and predictable trade policy requires a more realistic approach to trade negotiation that embraces plurilateral, bilateral, and regional processes. This, in turn, will maintain the momentum of change, creating more “facts on the ground.” For the World Trade Organization to remain relevant, it must view itself as the facilitator of all these processes and not exclusively as a forum for the exchange of multilateral concessions. Domestic mechanisms that require trade protection proposals to be examined transparently by broad constituencies will further guarantee a predictable trading regime. In an interconnected world, increased attention to trade facilitation is also needed to lower trade costs and consolidate the vested interest in and support for trade. These steps together will help to foster a liberal trading environment and prevent a future recourse to protectionism.

Is Protectionism Dying?

The limited resort to protectionism was a remarkable aspect of the Great Recession. Though the incidence of protectionist measures was significant and increased, and trade-discriminatory measures outnumbered trade-liberalizing measures by a wide margin, they covered only a small part of world trade. Furthermore, protectionist measures were most prevalent in countries with limited trade links with the global economy, notably India, Russia, and Argentina.¹

Despite persistent unemployment in developed countries, protectionism not only remained limited in scope but also appears to have subsided since the financial markets have stabilized. According to the World Trade Organization (WTO), protectionist measures covered just 0.2 percent of world trade between May and October 2010, down from 0.8 percent between October 2008 and October 2009. By contrast, the Great Depression of the 1930s was characterized by moderate across-the-board increases in tariffs from already-high levels that persisted for many years.²

Many factors contributed to limiting the extent of protectionism during the recent global economic crisis and recession. Crucially, concerted stimulus measures by the Group of Twenty, bank rescues, and the strengthening of lender-of-last-resort facilities helped contain the recession's duration and depth. Though many of these state assistance and bailout measures were discriminatory, they still helped prevent much worse outcomes. Automatic stabilizers and social safety nets that had been largely absent in the 1930s helped maintain macroeconomic stability and cushion the shock on the most vulnerable. Flexible exchange rates helped many countries adjust, whereas in the 1930s countries determined to keep their currency pegged to gold had suffered deflation and resorted to trade protection. World trade fell by almost 20 percent in the nine months between April 2008 and January 2009, but recovered to its previous level by the middle of 2010, a year during which it is estimated to have advanced by 13.5 percent; in contrast, global trade fell by 36 percent from 1929 to 1932 and recovered to its previous peak only in 1937.

Though the extent of the harm caused by the imposition of protectionist measures during the recent global crisis is unclear, the latest figures suggest few signs of a lasting impact on trade flows.

Though the extent of the harm caused by the imposition of protectionist measures during the recent global crisis is unclear, the latest figures suggest few signs of a lasting impact on trade flows.³ Despite large output gaps and persistent unemployment in the advanced countries, the volume of world trade in 2010 surpassed its peak level of 2008. Among those countries that imposed the most discriminatory measures during the crisis, India's import volumes as a percentage of gross national product (GDP) bounced back to their precrisis levels in 2010, and Argentina's were down by only 0.7 percentage points.⁴ Similarly, among those countries that were the top targets of trade-discriminatory measures during the crisis, China's export volumes as a share of GDP were 0.4 percentage points higher in 2010 than in 2008—reflecting the much stronger growth in trade activity in emerging economies—while exports as a percentage of GDP in the United States and Germany remained only 0.1 or 0.2 percentage points below 2008.

The WTO's disciplines, which are enforceable through its dispute settlement mechanism (DSM), also clearly played an important role in staving off trade protection; again, by contrast, these measures of course did not exist during the crisis of the 1930s. For example, the "buy American" provision in the 2009 U.S. stimulus act was moderated by the need to comply with obligations under the WTO-sponsored Government Procurement Agreement.⁵ In another instance, the U.S. Congress allowed a measure that prohibited imports of Chinese poultry to expire in 2008 after China initiated a WTO complaint challenging the ban.⁶ Beyond this deterrent effect, the DSM helped strike down protectionist measures during the global recession; for example, in November 2008, Thailand successfully challenged U.S. antidumping duties on carrier bags, and the United States abided by the WTO ruling.⁷

Despite the important role played by these institutions, however, there are many reasons to believe that multilateral disciplines are not the whole story, and probably not even the main story, of why protectionism was kept at bay during the recent global downturn.⁸ To begin with, the WTO's disciplines are notoriously porous, as shown by the several hundred protectionist measures nonetheless pursued during the crisis. Especially in times of great economic stress, protectionism can be and has been justified under safeguard and antidumping provisions. Countervailing duties, which the U.S. House of Representatives has recently threatened to apply to compensate for the undervaluation of the Chinese renminbi, are another remedy available under WTO provisions. Altogether, the independent organization Global Trade Alert counts 168 such "trade defense" measures since November 2008. All these instruments can be challenged and brought to the WTO's dispute settlement body. However, the delays and expenses associated with using the DSM, and the facts that adjudication is only among member states (not individual firms) and that remedies are confined to retaliatory trade measures, make the DSM a blunt instrument, especially if there are many disputes.

Moreover, the coverage of effective WTO disciplines is limited; large swaths of global trade in services and in agriculture and, in developing countries, of manufactured imports are still not subject to effective binding disciplines by the WTO, either because countries have not made commitments or because their actual trade policy is already more liberal than the commitments they did make—implying that they could increase protection while remaining within legal bounds. Indeed, these are precisely the main areas the WTO’s stuttering Doha Round of negotiations is intended to address.

What, then, is the rest of the story? Whereas multilateral disciplines certainly played a role in keeping protectionism at bay during the recent global crisis, other legal and structural changes in world trade during the past several decades have played a complementary and most likely even more important role. In particular, the embedding of liberalization in difficult-to-change national laws and the spread of regional trade agreements have not only strengthened the legal barriers against protectionism but have also created “facts on the ground,” in the form of increased dependence on trade and large investments directly or indirectly related to trade. These make a return to protectionism more costly and disruptive and establish new vested interests in open markets. As a result, all three overlapping layers of trade disciplines—national, regional, and multilateral—have become politically harder to challenge.

However, with trade barriers still high in large sectors of world trade and rising in some instances, we emphatically do not mean to convey a sense of complacency about protectionism. Although markets are more open and protectionism is now better contained than in the past, protectionism is far from extinct. What would have happened if globally coordinated stimulus and bank rescue legislation had not been enacted and if the global recession had turned into a second decade-long great depression? This question is currently of more than academic interest—if there were to be another financial meltdown, perhaps stemming from the sovereign debt crisis in the euro zone, governments’ capacity to react would be severely constrained by the legacy of the previous crisis, which includes high and rising debt burdens, an overhang of liquidity, and convalescing banks.

In fact, as is evident from the hundreds of measures enacted during the recent crisis, protectionism is not dying. And precisely for this reason, it is important to understand the forces that helped contain it. Building a more robust global trade architecture requires pursuing trade reforms across a broad front—national, regional, and multilateral—and maximizing the synergies among all three levels.⁹ As the conditions that encourage world trade to become even more prevalent and interconnected are established, protectionism will become ever more costly and politically charged.

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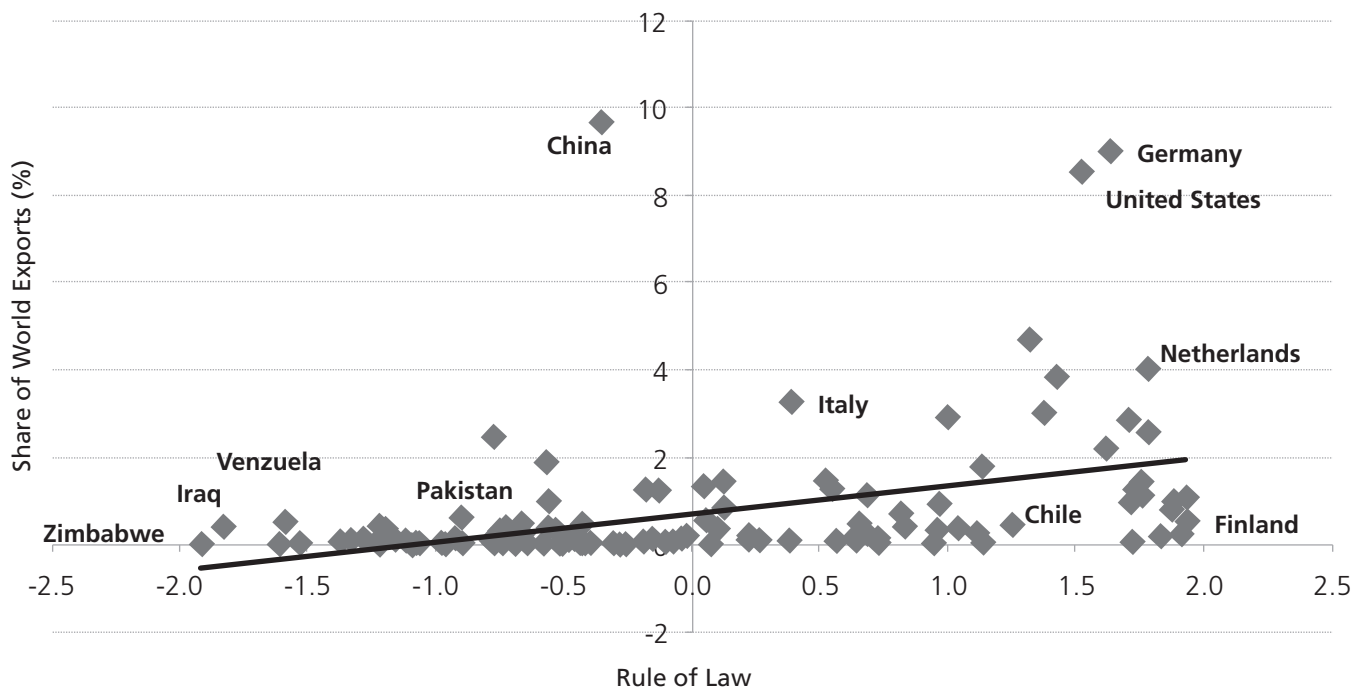
The Role of National Processes in Strengthening Trade Disciplines

Autonomous trade reform has been by far the largest source of liberalization in developing countries during the past thirty years, and such reforms have also historically played an important role in advanced countries.¹⁰ For example, unilateral trade liberalization has had twice as large an effect on trade growth in U.S. merchandise since 1980 as had multilateral trade liberalization.¹¹

The enactment of a liberal trade environment with strong legal institutions and property protections improves the confidence of importers and exporters alike, even in the absence of international trade agreements. This confidence is likely to be greatest where the rule of law is strongest, and indeed, though not necessarily demonstrating causality, there is a significant positive correlation between countries' scores of rule of law and their shares in world trade, indicating a possible relationship between the strength of a country's domestic legal infrastructure and its capacity to conduct trade. These rule-of-law scores vary greatly and are highest for nations that are the world's largest traders (figure 1). Exporters to Pakistan or Zimbabwe, relatively small markets with weak rule-of-law scores, might be less confident in the predictability of their trading

Figure 1

Rule of Law and Share of World Exports



Note: Based on a sample of 183 countries. The World Bank rule-of-law index is measured on a scale ranging from -2.5 to 2.5, with higher values corresponding to better governance outcomes.

Source: World Bank

environment than exporters to the United States, the EU nations, or Japan large markets with high rule-of-law scores—even when there is no trade agreement on which to fall back. Indeed, the variance in the rule of law is so great that an exporter from Russia, which is not a WTO member, might feel that the business environment is more predictable when exporting to the United States or the EU than when selling at home.

Along with a generally robust rule of law, national trade tribunals are another important national-level process that helps to prevent protectionism. Such courts provide a mechanism for individual firms to contest protectionist measures that implicate their company. In the United States, for example, the Department of Commerce and International Trade Commission are bound to conduct detailed investigations before imposing antidumping and countervailing duties on imports or safeguard measures; potentially affected domestic and foreign firms have a right to participate in the investigation and argue their case. This includes providing evidence on their trade practices in written questionnaires. Though this does not guarantee evenhanded treatment of domestic and foreign firms, the duties that have been imposed on companies that have participated in the process have generally been significantly lower than the average.¹²

Furthermore, there is a great deal of inertia in trade arrangements, even in cases where WTO disciplines are not binding. For example, in the United States, the enactment of a permanently higher tariff requires agreement by both houses of Congress and a decision by the president not to veto it. And in the European Union, a permanent tariff increase requires a decision by the Directorate-General for Trade, a qualified majority vote of the Council of Ministers representing 27 countries, and ratification by the European Parliament.

Finally, many national governments have also developed explicit or implicit mechanisms for countering protectionism and ensuring that trade policy reflects the general interest. Trade officials often lobby congressional and parliamentary bodies in opposition to protectionist bills that may arise in the legislative branch of government. For example, the Office of the U.S. Trade Representative has a section specifically dedicated to legislative issues headed by an assistant representative for congressional affairs. Though the office's political appointees reflect varied orientations toward trade, the bureaucracy itself nonetheless tends to foster a pro-free trade culture, which views more legal safeguards and transparency in bilateral trade relationships as serving the interests of the United States. Similarly, protrade bureaucratic interests can be found in China, where officials of the Ministry of Commerce have been described as “sponsors within the government for China's adoption of international practices,” including trade liberalization.¹³ Another institutionalized mechanism that deters protectionism is the Australian Productivity Commission, an independent and transparent research and advisory body that produces periodic reports that systematically analyze the economywide effects of trade barriers through an open, multistakeholder process.¹⁴

The Growing Role of Regional and Bilateral Trade Agreements in Assuring Predictability

Regional trade agreements (RTAs)—which include the European Union, the Europe Agreements, the Euro-Mediterranean Agreements, the North American Free Trade Agreement (NAFTA), the Central American Free Trade Agreement, the Gulf Cooperation Council, the Association of Southeast Asian Nations (ASEAN), Mercosur, and many others—now cover more than half of world trade in goods.¹⁵ These RTAs establish formalized tariff reductions that lower tariffs below most-favored-nation levels established in the WTO. In addition to codifying further tariff reductions, the agreements contain provisions establishing DSMs that the parties can use to contest violations of the agreement and thus defend against protectionism. Furthermore, RTAs have often established regular, high-level dialogues on trade disputes, treaty implementation, and further liberalization.

Not all dispute settlement processes are created equal, of course, but many RTAs, such as the European Union and NAFTA, contain credible and well-utilized procedures.¹⁶ For example, as of August 2004, NAFTA Chapter 19 dispute settlement panels—which review final cases of antidumping and countervailing duties—had convened in 103 cases since 1994. In most cases, the NAFTA dispute settlement review mechanism has lowered U.S. trade remedies against Canadian and Mexican exports.¹⁷ Unlike the WTO, some RTAs also include what are known as “investor-state” provisions (such as Chapter 11 of NAFTA), which enable firms to bring their grievances directly against the national government of the trading partner, without working through their own government. Enforcement strengthens the credibility of the RTA, making states more likely to carry out the agreement’s provisions; then, in cases where a violation is established, reciprocal trade remedies or even (as in the case of NAFTA) financial compensation punishes protectionism. This alters the calculus of firms in their lobbying of governments and shifts strategic preferences toward liberal trade policies.

Such agreements have often been criticized as creating a “spaghetti bowl” effect that makes discrimination the rule rather than the exception, obfuscates country-of-origin and other trade rules, and enables parties to pick and choose dispute settlement venues that will be more favorable to their cause—so-called forum shopping.¹⁸ They have also been criticized on the grounds that they are generally less rigorous and enforceable than the WTO’s DSM, and that even rigorous agreements are inherently less enforceable than the WTO, with its extensive body of jurisprudence established in precedent. However, other dispute settlement procedures often employ the WTO’s jurisprudence, incorporating the rulings of that body into their own decisions.¹⁹ Moreover, the dispute settlement procedures in each RTA are often better equipped to address

disputes specific to its provisions; these may or may not also be included in a country's WTO commitments.²⁰ Finally, because RTAs involve a smaller number of parties and entail clear commitments (often including the complete elimination of barriers on nearly all goods trade), they may be inherently less prone to violation and thus necessitate less resorting to dispute settlement in the first place.

RTAs also often establish regular high-level dialogues for the discussion of trade disputes, treaty implementation, and further liberalization. Such forums, typically held annually at a ministerial level with ongoing working groups, provide a mechanism for resolving serious violations of the agreement, even if its formal juridical mechanisms are not utilized. One example is the EU–Mexico Free Trade Agreement, which established a joint council that meets every other year and discusses a wide range of strategic issues, including trade-related concerns.²¹ Similarly, ASEAN, whose legal documents provide for a robust dispute settlement process that is nonetheless rarely used, convenes regular summits to address trade disputes and other issues. This emphasis on diplomatic rather than legalistic arbitration has been labeled the “ASEAN way”—a term that some use to disparage ASEAN's methods. But such criticisms overlook the effectiveness of high-profile shaming or back-patting in ensuring treaty compliance and deterring protectionism.

Outside these formal RTA/FTA relationships, some countries without bilateral trade treaties have also established regular high-level dialogues that furnish a direct diplomatic channel for resolving trade disputes and discussing further liberalization. One prominent example is evident in the United States–China relationship, where the Joint Commission on Commerce and Trade provides “the main forum for addressing bilateral trade matters and promoting commercial opportunities between the United States and China.”²² Through this commission, individual firms, as well as trade and industry groups such as the U.S. Chamber of Commerce and the U.S.-China Business Council, work closely with negotiators at the U.S. Department of Commerce and the Office of the U.S. Trade Representative to ensure that their trade concerns are addressed.²³

The Changing Political Economy of Protectionism

These political and institutional mechanisms have not only directly prevented protectionism, but have also fostered the increased interconnectedness of the global trading system, which is itself one of the most powerful barriers to protection. As trade has become a larger and more granular part of the world economy, the cost of protectionism has increased. In the 1930s, for example, trade (imports plus exports) represented 15 percent of global GDP and less than 10 percent of the U.S. economy, whereas today, with tariffs a fraction of what they were in the 1930s, trade accounts for 60 percent of global GDP and

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about 30 percent of the U.S. economy. The longer a liberal trade policy has been established, the more costly it becomes to reverse, as businesses are created and investments are made on the assumption that it will continue; thus, the vested interest in openness will tend to grow with time. These interests will manifest themselves in resistance to backtracking on both trade agreements and national laws.

Specifically, the political economy of protectionism pits the concentrated interests of import-competing sectors against the more diffuse ones of consumers, retailers, and firms that depend on imports for inputs as well as those multinational companies that depend on complex global production chains.

As trade has become a large part of economic activity and as globalized production chains have become more prevalent and complex, the size and influence of advanced economies' import-competing sectors have decreased and the size and degree of concentration in sectors favoring or at least tolerating open trade have increased.²⁴ For example, the textile and clothing industry in the United States employed 1.4 million of the nation's total 65 million private-sector workers in the early 1970s, compared with 200,000 of 110 million today. As a result of these trends, the political economy of protectionism has become less skewed in favor of import-competing sectors. The increased interest of retailers and consumers in imports, the internationalization of production, and the rise of intrafirm trade are all manifestations of these trends.

The Increased Interest of Retailers and Consumers in Imports

A high domestic value added is created from imports through distribution, marketing, and retail. Expenditures on transportation, storage, insurance, retailing, and the like contribute local value-added components to the final price of imports. Distribution margins (which include retail trade, wholesale trade, transportation costs, and value-added taxes) in many advanced economies are about 20 percent of purchasers' prices.²⁵ Though evidence on distribution margins from imports is very limited, one study estimated that transportation costs for U.S. imports from Japan or similarly distant countries as a share of customs value ranged from 6 to 16 percent.²⁶ Another example can be found in the importing of an iPod Touch to the United States, where 30 percent of the retail value is retained domestically through marketing and distribution.²⁷ Businesses that derive significant value added from imports will lose from a rise in tariffs.

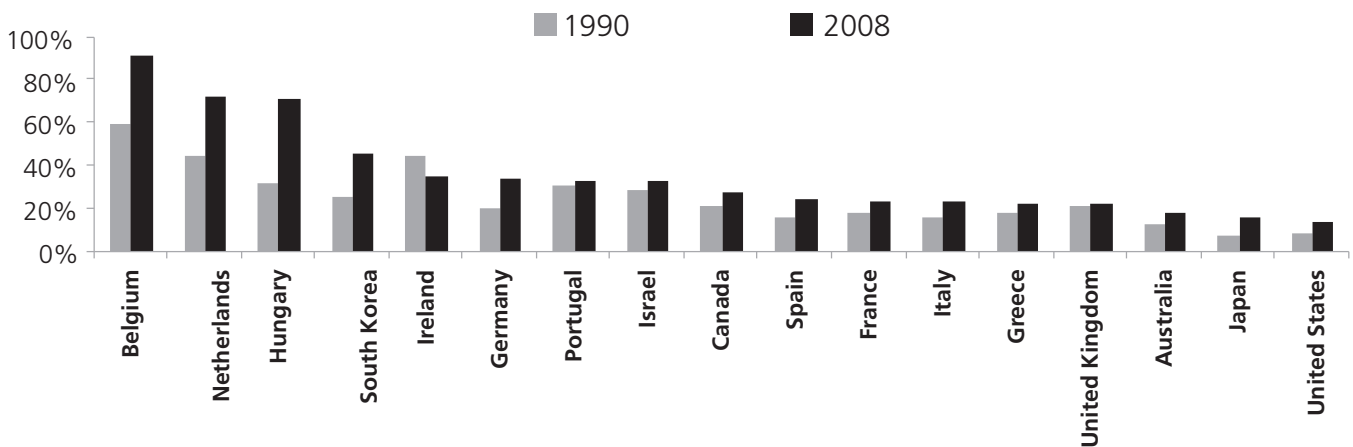
In addition, large and politically powerful companies, ranging from retailers to shippers, have come to depend on imports, which are often products for which comparably priced domestic goods are unavailable. For example, a third

of U.S. imports of textiles and apparels come from China, and many thousands of small and large businesses depend on imports of such goods. An increase in the cost of such imports due to high tariffs would have serious implications for the profitability of firms that depend on these imports, and thus, predictably, these firms lobby against a rise in trade barriers. For example, during the first half of 2010, Wal-Mart spent \$3.3 million on lobbying, which included opposing punitive legislation regarding Chinese imports and currency.

Another reason for resistance to higher trade barriers is the growing consumer preference for varied goods, a preference that is often satisfied through imports.

Figure 2

Import Penetration Ratio (Import of goods as a percentage of domestic demand)



Source: OECD

As figure 2 illustrates, the proportion of total expenditures spent on imported goods in countries that belong to the Organization for Economic Cooperation and Development (OECD) has been increasing in recent decades; in 2008, imported goods satisfied on average about 20 percent of domestic demand in many advanced economies, up from about 13 percent in 1990.

Although this increase in the volume of imports is the result of many factors—including higher incomes, falling transportation costs, and a decline in the relative price of imports—it also reflects a preference for a greater variety of goods. One study estimated that the variety of international goods imported into the United States tripled between 1972 and 2001.²⁸ Such an increase in import variety is often associated with gains in consumer welfare. For example, the average European consumer gains about €600 a year from the importing of a wider variety of goods and services.²⁹ New goods (“product proliferation”) also play an important role in the faster growth of imports.³⁰

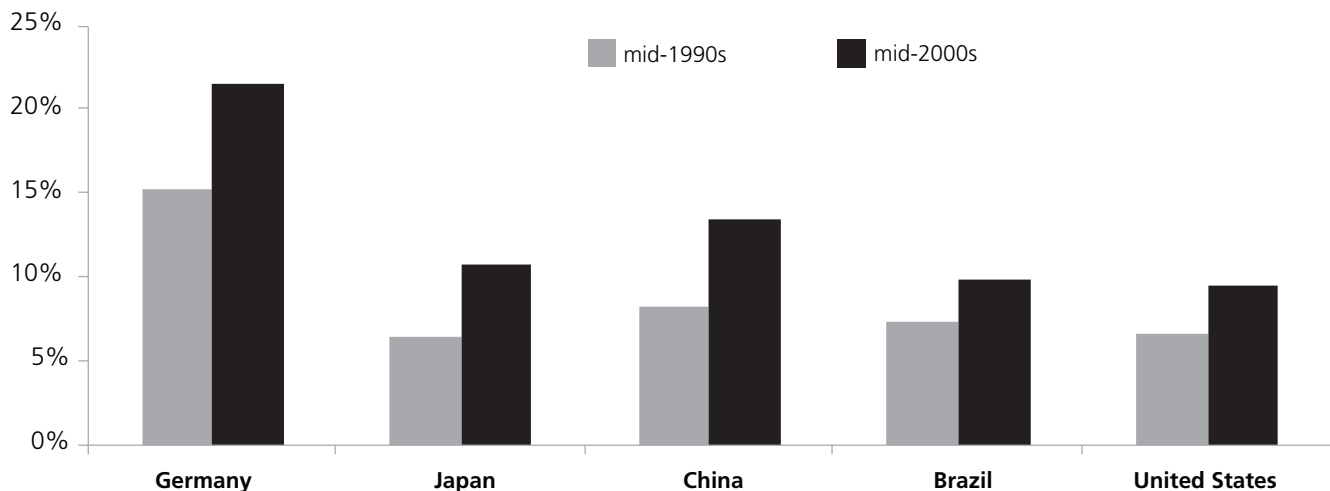
Still, trade barriers in advanced countries remain high with respect to household necessities, such as food and clothing, which represent a large share of purchases by low-income households, perhaps reflecting the latter's modest political influence.

The Internationalization of Production

Beyond retailers and consumers, many firms have come to rely on international supply chains, including imports of input components as well as exports of such materials to foreign manufacturers.³¹ Lower trade barriers, organizational innovations, and progress in information and communication technologies have made slicing up the production process cheaper and easier. As a result, the goods that constitute intermediate inputs have become an important part of world trade, and they thus now represent more than half the goods imported by OECD countries and close to three-fourths of the imports of the large developing economies, such as China and Brazil. As imports rather than domestic production are increasingly becoming the source of intermediate inputs, the intermediate import ratio—the ratio between intermediates imports and total intermediates demand—has increased sharply in recent years (see figure 3).

Figure 3

Intermediate Import Ratio (%)



Source: OECD I-O database

Most important, intermediate imports have become an increasingly important part of exports, while the domestic value added in production of exports has become less important. This implies that a nominal tariff represents a higher effective tariff—expressed as a share of domestic value added.

According to OECD estimates, imported intermediate input content accounted for about a quarter of OECD economies' exports in 2005.³² Reflecting the growing use of imported intermediates in exports, according to the OECD, all but one of its 34 member countries increased the import content of its exports during the period 1995–2005, with small economies, such as Luxembourg and Ireland, having larger increases. Thus, any initiative to increase protection across the board must contend with various unintended but predictable consequences: the depressing effects on domestic value added that come from penalizing distributors and retailers, along with the damages that arise from penalizing exporters, both directly (through higher prices of imported components) and indirectly (through possible retaliation). The danger of higher protection is particularly pronounced for smaller economies where the share of intermediate imports in a country's overall exports is large.³³

To further illustrate the damage that firms can suffer from protection, some studies also point to the fact that the prices of intermediate goods, for which demand is relatively inelastic, are also more sensitive to trade barriers than final goods.³⁴ The elasticity of substitution across separate stages of the production process is very low, which suggests that shocks in one country could be transmitted forcefully to links in the production chain located elsewhere.³⁵ Because of this sensitivity, higher trade barriers may also disrupt intraregional trade, given that countries tend to import intermediate inputs from other countries in their region. Higher trade barriers on intermediate goods in one country may also have an adverse impact on exports from the same country, by making final assemblers based overseas less profitable. For example, a tariff in Canada on imported car parts would imply lower profits for those U.S. car producers that import Canadian parts down the line, resulting in fewer Canadian exports.

Not surprisingly, firms engaged in producing and trading in intermediate goods tend to resist protectionism and view it as a direct threat to their production chain, market access, and, ultimately, profitability. As a result, some countries have implemented policies that give exporters duty-free access to imported intermediates. In Mexico, for example, foreign-owned production plants that process imported components for export benefit from Mexican laws that exempt imported parts and materials from tariffs.³⁶

Similarly, as outsourcing and offshoring have become common corporate strategies, opposition has grown to raising tariffs on intermediate goods and raw materials.³⁷ Because many foreign rivals can now produce in the domestic market, the benefits of protection for domestic firms have decreased and domestic industries thus have little incentive to lobby for import restrictions. Instead, domestic firms use alternative approaches to cope with global competition. For

example, companies in the television set and semiconductor industries, which had faced import competition in the past, now engage in joint ventures with foreign partners.

Perhaps for these reasons, there has been a marked decline in trade remedy filings in the United States in recent years—there were only 6 in 2010 compared with 80 to 100 a year between 1950 and 2000.³⁸ This decline in trade remedy actions is also evident in NAFTA's reviews of antidumping and countervailing duty dispute settlements.³⁹

The increasing internationalization of production also underscores the importance of trade facilitation—the reduction of on-the-border transaction costs, such as the standardization of customs formalities and greater port efficiency, and improvement in the regulatory environment in which trade transactions take place—in fostering a country's involvement in global production networks. In a world of low and declining tariffs, reducing other border-related trade costs, such as delays in the delivery of goods, has become the focus of

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trade policy. Such border-related costs may constitute as much as 15 percent of the value of the goods traded.⁴⁰ The benefits of more efficient border transactions could be more important than reducing tariffs, particularly in those developing countries that are saddled with inefficient customs procedures and backward infrastructures. For example, in Bolivia—a country with one of the lowest scores vis-à-vis the World Bank's Logistics Performance

Index—it is estimated that an improvement in the quality of infrastructure to half the level of Chile's—which has one of the best scores for this index in Latin America—would increase the volume of exports by 49.1 percent, equivalent to a 33.6 percent reduction in import tariffs.⁴¹ In short, improvements in trade facilitation indicators would generate a significant increase in trade flows.

The Rise of Intrafirm Trade

A special case of the internationalization of production with important consequences for the political economy of protectionism is intrafirm trade—that is, trade among multinational companies and their affiliates. In this case, the costs of raising tariffs on parts and components are directly borne by domestic companies, so the protection that occurs is effectively against a country's own firms. Although this does not (and has not) prevented the erection of protectionist barriers in some instances, countries will clearly be more reluctant to erect barriers that depress the profits of domestic firms, and the latter can be expected to exercise their influence to resist.

The intrafirm trade of U.S. multinational corporations with their majority-owned affiliates abroad amounted to about 40 percent of total U.S. trade during the past ten years. Intrafirm trade also accounted for a large share of

U.S. bilateral trade—nearly 30 percent of U.S. imports from China in 2009, and about 80 percent of imports from Japan. Though data on the ownership nationalities of importing firms is not available, anecdotal evidence suggests that Japanese intrafirm shipments to the United States are likely trades between Japanese parents and U.S. subsidiaries, while China’s intrafirm shipments are more likely between Chinese subsidiaries and U.S. parents. In Japan, intrafirm trade in 1999 accounted for around a third of its goods exports and a quarter of goods imports. In addition, the nature of intrafirm trade may vary, depending on the trading partners. Though much of the intrafirm trade between high-income economies may be in finished goods for marketing and distribution, with little processing, intrafirm trade between high- and middle-income economies is likely to include a high proportion of parts used in manufactures destined for both domestic and world markets.

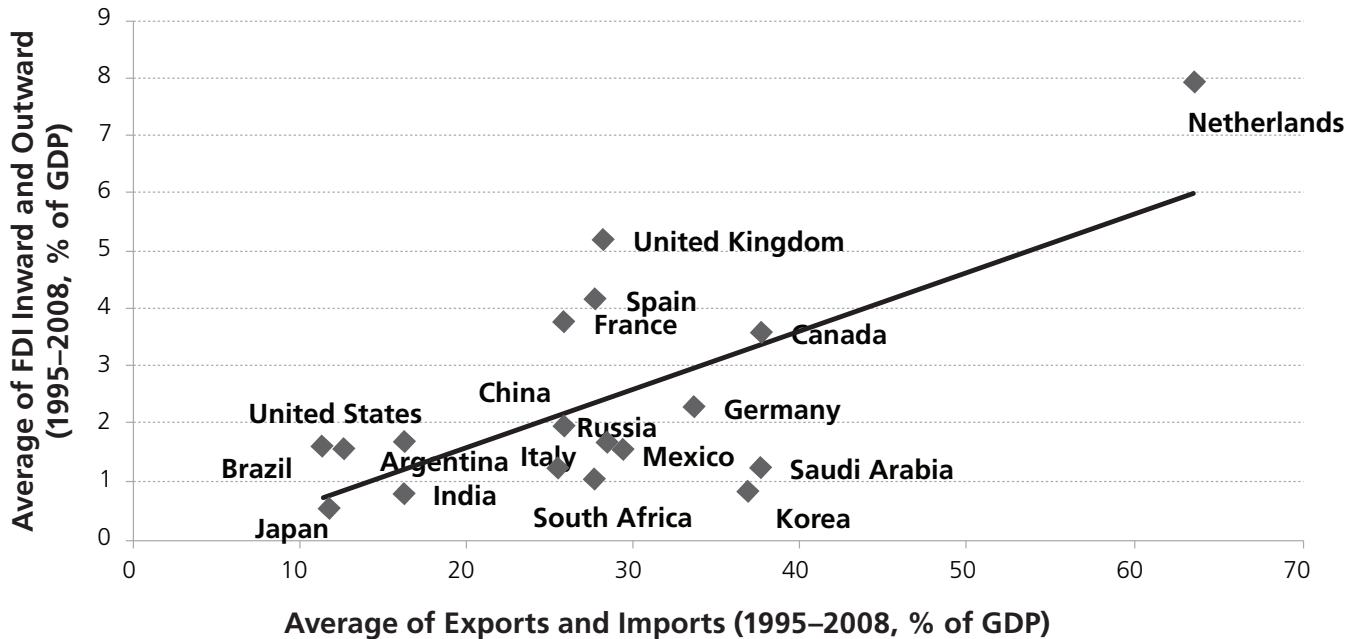
Many studies have examined the effects of intrafirm trade, including how it shapes incentives for protection.⁴² Exporting firms or firms that have a large overseas production base will be concerned not only with the added costs to their imports of parts but also about retaliation that may affect their overseas investments. Protecting the home market may also be less valuable if foreign competitors divert their products to third markets. Internationally oriented firms that source heavily overseas will also find that protection puts them at a disadvantage with respect to more domestically oriented rivals.

The fierce global competition to attract foreign direct investment (FDI) also contributes to making the political economy of protectionism more complicated, and is believed to be generally less favorable for protection. According to a study involving U.S. subsidiaries in the EU, the presence of large stocks of FDI originating in the United States reduced the incentive to use restrictive import policies in the EU because of fears that the FDI would migrate.⁴³ Although “tariff hopping” has traditionally been seen as an important motivation for FDI, the evidence points to the contrary: More open economies generally enjoy higher FDI, as shown in figure 4. As always, causality is difficult to establish, but the fact that foreign subsidiaries have become increasingly important in multinational corporations’ strategy, for purposes of distribution and domestic marketing as well as production for export to home and foreign markets, clearly creates a preference for countries with relatively open and predictable trade regimes. Such a regime would be associated with a generally business-friendly environment, which would also help attract investment.

The fact that foreign subsidiaries have become increasingly important in multinational corporations’ strategy, clearly creates a preference for countries with relatively open and predictable trade regimes.

Figure 4

FDI and Trade Openness



Sources: World Bank and UNCTAD

Policy Implications

The increased resistance to protectionism, which the recent global economic crisis has brought to the fore, is the result of a complex, mutually reinforcing set of legal and structural changes in the world economy. The WTO's disciplines are only one part, and the slowest changing, of the legal landscape affecting trade, as national laws and regional deals play a crucial and increasingly important complementary role. At the same time, the political resistance to backsliding on liberalization is also stronger, because trade has become more prevalent and inextricably woven into production and consumption patterns. Increasingly, limiting trade in any one sector not only hurts consumers but also has repercussions for firms that operate both vertically (within a sector) and horizontally (across sectors). Retaliation has equally complex ramifications, and because the shape it will take is unknown, inviting retaliation increases uncertainty across a broad spectrum of activities and interests.

Although national and regional liberalization and the internationalization of production have deterred protectionism, there is a fly in the ointment. Even as firms and consumers have come to rely on the globalized environment, these same factors are a possible source of the lagging impetus for a broad

multilateral trading agreement. One reason for this sense of complacency is that a major element of a potential Doha Round agreement would be to lock in the unilateral liberalization that has already occurred. Such an outcome would have little immediate appeal to corporate lobbyists and politicians, who might tend to view a rise in tariffs above current levels as relatively unlikely. Many observers have also pointed to the role that RTAs could play in diminishing the sense of urgency and exhausting the political capital and resources necessary for a multilateral agreement under the auspices of the WTO.⁴⁴ Finally, as noted, firms could feel that expending their energies on improved trade facilitation in individual countries or regions would pay higher dividends than pursuing a global trade deal.

No doubt, establishing tighter WTO bindings in crucial areas of trade (services, manufactured imports in developing countries, and agriculture) would add significantly to the predictability of trade in the long run and also strengthen the WTO as an institution. However, the combination of advancing and difficult-to-reverse liberalization on the one hand and increasing the complexity and unwieldiness of WTO negotiations on the other have greatly exacerbated the problem of collective action. Partly for these reasons, a number of proposals have been made in favor of moving away from the single undertaking and toward “critical mass” or “plurilateral” approaches that would better enable constituencies to mobilize around specific sectors or issues.⁴⁵

Six other broad conclusions that bear on trade policy arise from this review of trade during the crisis. First, assuring an open and predictable trade regime requires sound macroeconomic policies, financial regulation, and social safety nets that limit the impact of economic downturns. Good trade policy depends on good macroeconomic and social policy.

Second, in an interconnected world, the costs of protectionism have risen sharply and its effects are more difficult to predict, making it an increasingly risky and dangerous policy tool.

Third, given the centrality of autonomous trade disciplines, the domestic forces opposing protectionism should be mobilized more systematically by ensuring that trade protection proposals are examined transparently and by broad constituencies, for example, as is done under the Australian Productivity Commission.

Fourth, contrary to those who insist on focusing exclusively on “first best” multilateral approaches to trade liberalization, a more realistic approach would exploit any and all possible mechanisms—including plurilateral, bilateral, and regional processes—which has the merit of maintaining and strengthening the momentum of change. In practice, from the standpoint of both individual

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countries and the trading system as a whole, there are important synergies to be drawn between national, regional, and multilateral approaches to liberalization, each of which has its strengths in particular circumstances.

Fifth, in the same spirit of building “facts on the ground,” increased attention to trade facilitation not only directly lowers trade costs but also consolidates the vested interest in and support for trade.

Sixth and finally, important as multilateral disciplines are, to maximize its impact (indeed, to remain relevant) the WTO must view itself as the facilitator of all the above-described processes, and not exclusively as a forum for the exchange of multilateral concessions.⁴⁶

These steps will help foster a liberal trading environment, strengthen resistance, and prevent a return to protectionism.

Notes

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- 1 According to Global Trade Alert (GTA) 2009, trade-discriminatory measures during the crisis outnumbered trade-liberalizing measures by six to one. The EU is also listed as among the most frequent user of protectionist measures, but this included bank and other bailouts whose primary intent was not protectionist. Simon Evenett, ed., “The Unrelenting Pressure of Protectionism: The 3rd GTA Report,” *Global Trade Alert*, Centre for Economic Policy Research, 2009.
- 2 The effect of trade barriers during the Great Depression was much larger as most tariffs, including most of the Smoot-Hawley tariffs in the United States, were in specific terms and the deflation in the 1930s significantly raised the ad valorem equivalent of the duties. In contrast, about 99 percent of import tariffs today are in ad valorem, or percentage of value, which implies that declining import prices result in smaller tariff payments. See Douglas Irwin, “Historical Perspectives on U.S. Trade Policy,” *NBER Reporter*, Winter 1998/1999, www.nber.org/reporter/winter99/irwin.html.
- 3 Some studies suggest that very few protectionist measures introduced since the outbreak of the crisis have actually been removed so far. See Gary Hufbauer, Jacob Kirkegaard, and Woan Foong Wong, *G-20 Protection in the Wake of the Great Recession* (Washington, D.C.: Peterson Institute Press, 2010); and World Trade Organization, *Report on G20 Trade Measures: May 2010–October 2010* (Geneva: World Trade Organization, 2010).
- 4 Among countries that were engaged in most trade-discriminatory measures, Russia seems to have lost a significant share of its imports: import volumes in 2010 were down 2.3 percent of GDP from 2008 levels.
- 5 For example, see Senator John McCain (R-AZ), remarks upon introducing Amendment no. 279, Congressional Record-Senate 155 (February 4, 2009) S1494-S1496, U.S. Government Printing Office, www.gpo.gov. In his remarks, McCain explicitly referred to U.S. obligations under the WTO GPA and NAFTA and the potential negative repercussions that violating those agreements might bring to the U.S. economy. McCain’s amendment was ultimately rejected, but several exceptions were added to the Buy American provisions in the stimulus bill. See H.R. 1–189, Sec. 1605: Buy American, U.S. Government Printing Office. Also, a special negotiated agreement was reached with Canada to allay the effects of the Buy American requirement. See “Joint Statement on Canada-U.S. Agreement on Government Procurement,” Foreign Affairs and International Trade Canada,

February 5, 2010, www.international.gc.ca/media_commerce/comm/news-communicues/2010/055.aspx?lang=eng.

- 6 Congressional debate and lobbying by industry groups highlighted the need to adhere to WTO obligations. See Representative Kevin Brady (R-TX), remarks on the provision banning the importation of poultry from China, Congressional Record-House 155 (July 8, 2009) H7790, U.S. Government Printing Office. Brady included a letter to President Obama from industry associations arguing that the ban on Chinese poultry “conflicts with the U.S. obligation to treat trading partners equally” and urging him “to oppose any provisions in the annual appropriations bills that may be inconsistent with our trade obligations under the provisions of World Trade Organization (WTO) agreements.”
- 7 See World Trade Organization Dispute Settlement Gateway, www.wto.org/english/tratop_e/dispu_e/dispu_e.htm#disputes. In all, as of January 21, 2011, 41 disputes have been brought to the WTO since the beginning of September 2008 to challenge various alleged protectionist measures; half are currently in consultations and the other half are proceeding through the panel or appellate process.
- 8 Although at least one study has challenged the argument that WTO membership provides a more liberal trade policy, other studies have suggested that the GATT/WTO has exerted a positive effect on trade among signatories and nonmembers alike. See Andrew K. Rose, “Do We Really Know That the WTO Increases Trade?” Center for Economic Policy Research, Discussion Paper 3538, September 2002; and Michael Tomz, Judith L. Goldstein, and Douglas Rivers, “Do We Really Know That the WTO Increases Trade? Comment,” *American Economic Review*, vol. 97, no. 5 (December, 2007): 2005–18. Other studies have shown that the effects of GATT/WTO membership can be positively identified among industrial countries that made commitments but cannot among developing countries. See Arvind Subramanian and Shang-Jin Wei, “The WTO Promotes International Trade, Strongly but Unevenly,” National Bureau of Economic Research Working Paper 10024, October 2003. Another study found that the United States is less likely to impose antidumping duties on GATT/WTO members, demonstrating the power of WTO membership to deter protectionism. See Marc L. Busch, Rafal Raciborski, and Eric Reinhardt, “Does the Rule of Law Matter? The WTO and U.S. Antidumping Investigations,” originally presented at the 2005 Annual Meeting of the American Political Science Association, Washington, D.C., typescript, March 27, 2009.
- 9 Such a strategy has been advocated by Alejandro Jara, who has lauded the “virtues of promiscuity” in trade promotion policy. Alejandro Jara, “Las Virtudes de la Promiscuidad,” in *Regionalismo Global: Los Dilemas para América Latina*, edited by Ramón Torrent and Antoni Esteveordal (Barcelona: Fundació CIDOB, 2005). This strategy would also resemble the central elements of a “competitive liberalization” approach, which was discussed as early as 1996 in C. Fred Bergsten, “Globalizing Free Trade,” *Foreign Affairs* (May/June, 1996), 105–6. Former U.S. Trade Representative (now World Bank president) Robert Zoellick also advocated “a strategy of ‘competitive liberalization’ to advance free trade globally, regionally, and bilaterally,” which would entail “moving forward simultaneously on multiple fronts” in trade negotiations. See Zoellick’s letter to David M. Walker in United States General Accounting Office, *International Trade: Intensifying Free Trade Negotiating Agenda Calls for Better Allocation of Staff and Resources*, GAO 04-233 (Washington: GAO, 2004): 57.

This approach shares some similarities with the domino effect discussed in Richard E. Baldwin, “A Domino Theory of Regionalism,” NBER Working Paper no. 4465, 1993. For a more recent confirmation of the domino/contagion effect of free trade agreements, see Richard Baldwin and Dany Jaimovich, “Are Free Trade Agreements Contagious?” NBER Working Paper 16084, June 9, 2010.

- 10 According to Ng and Martin (2004), unilateral reforms accounted for two-thirds of tariff cuts in all developing countries between 1983 and 2003, compared to only 25 percent due to implementation of the Uruguay Round and 10 percent due to regional agreements and expansion of trade. Will Martin and Francis Ng, “Sources of Tariff Reductions,” background paper for *Global Economic Prospects: Trade, Regionalism, and Development* (Washington, D.C.: World Bank, 2005). For a discussion of several political economy mechanisms behind unilateral liberalization in developing economies, see Richard Baldwin, “Unilateral Tariff Liberalization,” *International Economy* (Journal of the Japan Society of International Economics), no.14 (2010): 10–43.
- 11 Matthew Adler and Gary Hufbauer, “Policy Liberalization and US Merchandise Trade Growth, 1980–2006,” Peterson Institute for International Economics Working Paper no. 09-2 (Washington: Peterson Institute Press, 2009).
- 12 For example, final antidumping duties imposed by the USITC on May 21, 2010, on oil country tubular goods from China were 32.07 percent on the 39 Chinese exporters who had submitted questionnaires to the USITC, while the general PRC-wide rate was 99.14 percent. Another example from the same year is found in the final antidumping duties imposed June 29, 2010 on Chinese imports of prestressed concrete steel strands, which were 42.97 percent on one Chinese exporter that submitted documentation to the USITC and 175.94 percent on two other Chinese exporters that submitted an initial questionnaire but failed to provide follow-up information; in contrast, the general PRC-wide rate was 193.55 percent. See U.S. International Trade Commission database of AD CVD Investigations at www.usitc.gov/trade_remedy/731_ad_701_cvd/investigations/completed/index.htm#final.
- 13 Wei Liang, “Bureaucratic politics, interministerial coordination and China’s GATT/WTO accession negotiations,” in *China’s Foreign Trade Policy: The New Constituencies*, edited by Ka Zeng (New York: Routledge, 2007), 20–39.
- 14 For example, see the commission’s report on bilateral and regional trade agreements www.pc.gov.au/__data/assets/pdf_file/0010/104203/trade-agreements-report.pdf.
- 15 As of July 2010, a total of 474 RTAs have been notified to the WTO, of which 283 agreements were in force at that time.
- 16 William J. Davey, “Dispute Settlement in the WTO and RTAs: A Comment,” in *Regional Trade Agreements and the WTO Legal System*, edited by Lorand Bartels and Federico Ortino (New York: Oxford University Press, 2006); Yan Luo, “Dispute Settlement in the Proposed East Asia Free Trade Agreement: Lessons Learned from the ASEAN, the NAFTA, and the EU” in Bartels and Ortino, eds., *Regional Trade Agreements and the WTO Legal System*.
- 17 Gary Hufbauer and Jeffrey Schott, “NAFTA Revisited: Achievements and Challenges,” no. 332, Peterson Institute for International Economics (Washington: Peterson Institute Press, 2005).
- 18 For a discussion of the spaghetti bowl effect, see Jagdish Bhagwati and Anne O. Krueger, *The Dangerous Drift to Preferential Trade Agreements* (Washington, D.C.: American Enterprise Institute Press, 1995). For discussions of forum shopping, see

- Kyung Kwak and Gabrielle Marceau, “Overlaps and Conflicts of Jurisdiction between the WTO and RTAs,” in Bartels and Ortino, eds., *Regional Trade Agreements and the WTO Legal System*; and Marc L. Busch, “Overlapping Institutions, Forum Shopping, and Dispute Settlement in International Trade,” *International Organization*, vol. 61, no. 4 (Autumn, 2007): 735–61.
- 19 Locknie Hsu, “Applicability of WTO Law in Regional Trade Agreements: Identifying the Links,” in Bartels and Ortino, eds., *Regional Trade Agreements and the WTO Legal System*.
 - 20 Some RTAs provide a venue for trade litigation among states that are not yet members of the WTO and thus are not incorporated under the legal umbrella of the WTO DSU. The Central European Free Trade Agreement (CEFTA), for example, fills such a role for member states that have not acceded to the WTO, such as Serbia, Montenegro, and Bosnia and Herzegovina.
 - 21 For example, in the sixth and most recent meeting of the EU-Mexico Joint Council, the parties agreed to pursue further liberalization “in the areas of agriculture and fishing, services and investment,” as well as “progress towards a cumulation of origin between Mexico, EU and their common Latin-American trade partners.” See Joint Communiqué, VI Joint Council EU-Mexico, Prague, Czech Republic, May 14, 2009, Council of the European Union 8436/09 (Presse 79): 7, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/er/107715.pdf.
 - 22 “Commerce Secretary Gary Locke and USTR Ronald Kirk Convene 20th Session of U.S.-China Joint Commission on Commerce and Trade in Hangzhou, China,” Office of Public Affairs, U.S. Department of Commerce, October 21, 2009, www.commerce.gov/news/press-releases/2009/10/21/commerce-secretary-gary-locke-and-ustr-ronald-kirk-convene-20th-sessi.
 - 23 Such trade issues were also addressed in the U.S.-China Strategic Economic Dialogue (SED), established in 2006 under the Bush administration, a brainchild of Treasury Secretary Henry Paulson. While bilateral economic issues are still ostensibly included under the purview of the Obama administration’s modified Strategic and Economic Dialogue (S&ED), this latter forum, which also involves the U.S. secretary of state and the Chinese foreign minister, places more emphasis on broader strategic and political issues.
 - 24 For example, textiles production (in current dollars) in the United States, United Kingdom, and Japan fell by between 28 and 40 percent between 2000 and 2007.
 - 25 Linda Goldberg and Jose Manuel Campa, “Distribution Margins, Imported Inputs, and the Insensitivity of the CPI to Exchange Rates,” Working Paper no. 12121, National Bureau of Economic Research, 2002.
 - 26 James Rauch, “Networks versus Markets in International Trade,” *Journal of International Economics*, vol. 48, no. 1 (June 1999): 7–35.
 - 27 Greg Linden, Kenneth L. Kraemer, and Jason Dedrick, “Who Captures Value in a Global Innovation System? The Case of Apple’s iPod,” Personal Computing Industry Center, University of California Irvine, 2007.
 - 28 Christian Broda and David E. Weinstein, “Globalization and the Gains from Variety,” *Quarterly Journal of Economics* 121, no. 1 (2006): 541–85.
 - 29 European Commission, “Trade, Growth, and World Affairs: Trade Policy as a Core Component of the EU’s 2020 Strategy,” http://trade.ec.europa.eu/doclib/docs/2010/november/tradoc_146955.pdf.

- 30 Paul Krugman, “Differences in Income Elasticities and Trends in Real Exchange Rates,” *European Economic Review*, vol. 33, no. 5 (May 1989): 1031–46.
- 31 According to an OECD study, multinational enterprises (MNEs) can be distinguished according to the type of FDI they engage in: vertical MNEs and horizontal MNEs. A firm that transfers part of the production process abroad is classified as a vertical MNE, while a multinational that establishes facilities replicating the entire production process in a foreign country is called a horizontal MNE. Sebastien Miroudot and Alexandros Ragoussis, “Vertical Trade, Trade Costs and FDI,” OECD Trade Policy Working Papers, no. 89, 2009.
- 32 Unless otherwise indicated, data on import content of exports is from the OECD Input-Output database. It should be noted that estimates vary widely depending on the data, assumptions, and methodology used. For example, estimates of the share of Chinese exports accounted for by imported intermediates can vary from 45 percent to 65 percent. See Congressional Budget Office, “The domestic value added of Chinese exports,” Appendix A to accompany *How Changes in the Value of the Chinese Currency Affect U.S. Imports*, July 2008, www.cbo.gov/ftpdocs/95xx/doc9506/AppendixA.pdf.
- 33 Shimelse Ali and Uri Dadush, “Rise of Trade in Intermediates: Policy Implications,” *International Economic Bulletin*, Carnegie Endowment for International Peace, February 10, 2011.
- 34 WTO, “Vertical Specialization and the Quality of Infrastructure,” ERSD Staff Working Paper no. 2003–2004; and Sebastien Miroudot, Rainer Lanz, and Alexandros Ragoussi, “Trade in Intermediate Goods and Services,” Trade Policy Working Paper no. 93, OECD, 2009.
- 35 Kevin O’Rourke, “Collapsing Trade in a Barbie World,” blog post, Irish Economy, June 18, 2009, www.irisheconomy.ie/index.php/2009/06/18/collapsing-trade-in-a-barbie-world.
- 36 David Hummels, Jun Ishii, and Kei-Mu Yi, “The Nature and Growth of Vertical Specialization in World Trade,” *Journal of International Economics* 54 (2009).
- 37 A number of studies have explored these issues. For example, see Douglas A. Irwin, “Trade Policy in 2008: Great Depression Redux?” in *What World Leaders Must Do to Halt the Spread of Protectionism*, edited by Richard Baldwin and Simon Evenett, VoxEU.org, Centre for Economic Policy Research, 2008: 59–62.
- 38 For example, a 2004 antidumping (AD) investigation on wooden furniture from China to the United States was opposed by many furniture retailers, who feared that the higher prices caused by AD duties would depress sales and result in layoffs of employees. See Vivian C. Jones, “Trade Remedies: A Primer,” Congressional Research Service Report for Congress, 2007.
- 39 There have been only six Canadian cases against the United States completed under NAFTA’s Chapter 19 dispute settlement review since 2000, compared to 23 cases between 1989 and 1994, when the Free Trade Agreement was supplanted by NAFTA. See Lawrence Herman, “Trend Spotting: NAFTA Disputes After Fifteen Years,” C.D. Howe Institute Backgrounder, issue 133, 2010.
- 40 Chahir Zaki, “Does Trade Facilitation Matter in Bilateral Trade?” Documents de travail du Centre d’Economie de la Sorbonne bla08100 (Paris: Centre d’Economie de la Sorbonne, 2007).

- 41 Alberto Portugal-Perez and John Wilson, "Export Performance and Trade Facilitation Reform," Policy Research Working Paper 5261 (Washington: World Bank, 2010).
- 42 Helen Milner, "Resisting the Protectionist Temptation," *International Organization* 41(1987): 639–65; John Odell and I. M. Destler, *The Politics of Anti-Protection* (Washington: Institute for International Economics, 1987); and Thomas A. Pugel and Ingo Walter, "U.S. Corporate Interests and the Political Economy of U.S. Trade Policy," *Review of Economics and Statistics* 6, 1985.
- 43 Giorgio Barba Navaretti, Jan I. Haaland, and Anthony Venables, "Multinational Corporations and Global Production Networks: The Implications for Trade Policy," report prepared for the European Commission Directorate General for Trade, Center for Economic Policy Research, 2001.
- 44 Jagdish N. Bhagwati, *Termites in the Trading System: How Preferential Agreements Undermine Free Trade* (Oxford; New York: Oxford University Press, 2008); Richard Baldwin and Dany Jaimovich, "Contagious FTAs: New evidence on the domino theory of regionalism," VoxEU.org, September 2, 2010, www.voxeu.org/index.php?q=node/5457; and Jeffrey J. Schott, "The future of the multilateral trading system in a multi-polar world," Discussion Paper, Deutsches Institut für Entwicklungspolitik, 2008.
- 45 For a discussion of such proposals, see High-Level Trade Experts Group, "The Doha Round: Setting a deadline, defining a final deal," Interim report, 2011; and Uri Dadush, "WTO Reform: The Time to Start Is Now," Policy Brief (Washington: Carnegie Endowment for International Peace, 2009).
- 46 Dadush, "WTO Reform: The Time to Start Is Now."

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