U.S. Foreign Economic Policy in the Global Crisis

Testimony of

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Before the

Subcommittee on Terrorism, Nonproliferation and Trade

of the

House Committee on Foreign Affairs

12 March 2009

Chairman Sherman, Ranking Member Royce, and members of the subcommittee, thank you for the opportunity to testify today on the international economic policy challenges facing the United States in this time of global crisis. You are to be applauded for holding this hearing and recognizing that, in this time of domestic distress, our foreign economic policies will have important and long-lasting ramifications.

The crisis began with a drop in housing prices, continued with a crisis in financial markets, and has led to a sharp worldwide downturn in production and trade. We have seen calls for a global response to this global challenge, but there has been strikingly little coordinated action to date.

I hope to describe some of the ways in which the crisis affects our foreign economic policy both directly and indirectly. As significant as the difficulties have been to date, I would also suggest that we must be prepared for additional strains in the near future.

I will place particular emphasis on the importance of maintaining the United States' leadership role in pursuing open markets. If we deviate from this, we risk launching a wave of protectionism around the world. There are difficult choices to be made, but I will argue that the policies that will serve us best on the international stage are also those that we should pursue for domestic prosperity.

1. Direct Effects of the Economic Crisis

The global crisis has significantly weakened both the traditional allies of the United States and those nations with whom we have often disagreed. As just one measure of the impact, the World Bank reported this week that global industrial production declined by 20 percent in the fourth quarter of 2008.[1] Even in relatively prosperous nations, this sort of shock can shake public confidence in governments and economic approaches. In less prosperous nations, it can bring poverty, despair, and can threaten the stability of the country. The crisis thus threatens long-standing goals of U.S. foreign economic policy such as global development and poverty alleviation. At the same time, as allied nations have seen much of their wealth dissipate, they have fewer resources available to attack these global problems of common concern.

The financial nature of this crisis has also had a particularly debilitating effect on Europe, since it has highlighted some of the weaknesses of European monetary integration, a policy that is at the heart of European cooperation. Critics such as Martin Feldstein have long questioned the advisability of a single currency for Europe.[2] Much of this skepticism was based on the argument that economic shocks would affect different countries differently and result in disagreements over how to react. That has happened. We've also discovered new weaknesses in the structure. Whereas there is a European Central Bank to set monetary policy, there is no body that plays a similar broad role in regulating financial institutions or providing fiscal assistance. This lack has led to serious concerns when one nation charged ahead of others in offering support for faltering banks, for example. While European leaders have been at the forefront of calls for a globally

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[1] World Bank, "Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis," March, 2009.

[2] For a recent statement, see Martin Feldstein, "Reflections on Americans' views of the euro ex ante," VoxEU, 26 January 2009 at http://www.voxeu.org/index.php?q=node/2867.

coordinated response, Europe has had ample difficulties internally and the perilous finances of some member states promise more difficulties to come.

It might seem to be a silver lining to the cloud of crisis that our adversaries are being weakened as well. However, desperate and impoverished governments can take drastic and unsavory actions to salvage their domestic standing and raise resources. Some nations that flourished under booming commodity prices may be tempted to turn to trade in arms or narcotics when the price of oil falls to roughly one third of its recent highs.[3]

2. Challenges to U.S. International Economic Leadership

Some of the most serious policy effects of the crisis are indirect. They stem from official and private reactions to the economic shock. In the areas of international trade and open markets, developments spurred by the crisis have threatened the leadership role that the United States has played since the Second World War.

The propensity to turn inwards in a time of economic crisis is not new.[4] One of the perpetual challenges for trade liberalization is that the benefits tend to be diffuse – lower prices for consumers, market access for exporters – while the costs of import competition tend to be concentrated. These costs are felt more acutely in times of economic distress. The misguided attempts to protect domestic producers by raising trade barriers in the 1930s were a major motivation for the post-war trading system. Under a succession of negotiating rounds that culminated in the present-day World Trade Organization, that system has offered a rules-based trading environment conducive to growth and increasing prosperity.[5]

Despite the creation of the WTO in the last completed trade round, the global trading system is more feeble than it appears.[6] The WTO sits astride a set of agreements between member countries, but it has no enforcement power. Instead, dispute settlement panels determine when a member country has reneged on a commitment. The complaining party is then authorized to retaliate if the violation is not set right.

These seemingly arcane details of WTO operation mean that the trading system largely relies upon the willingness of its major members to honor the letter and spirit of agreements. If they do not, there is little to hold the system together.

Even before the recent economic shocks hit, the WTO was suffering a crisis of its own. It repeatedly failed to conclude the latest round of talks, begun in 2001 in Doha, Qatar. Those talks demonstrated the difficulties the WTO faces as its membership surpassed 150 countries at all different stages of development. In the postwar era, there has not been a failed round of global trade talks. Such a failure threatens to drive members to litigation in lieu of negotiation at just the moment when the willingness to

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[3] Some of these questions were addressed at an American Enterprise Institute event on "The Future of Hugo Chavez's Petro-Diplomacy" on February 11, 2009. A record of that event can be found at http://www.aei.org/events/filter.all,eventID.1882/event_detail.asp.
[4] See, for example, Jagdish Bhagwati, Protectionism, MIT, 1989.
[5] For a quantification of this, see Scott C. Bradford, Paul L.E. Grieco, and Gary Clyde Hufbauer, "The Payoff to America from Global Integration," Ch. 2 in Fred Bergsten, ed., The United States and the World Economy, Institute for International Economics, 2005.
[6] This argument is developed in Philip I. Levy, "Does Trade Policy Matter?" *International Economic Outlook,* No. 1, American Enterprise Institute, October 2008.

honor agreements may be at low ebb. To the extent the United States forsakes constructive engagement at the WTO in favor of enforcement actions, it will be adding strains that the system is ill-equipped to bear.

The United States plays a special role at the WTO. It has pushed for liberalization and led by example. U.S. trade negotiating authority has set the timetable for the rounds that have structured the trading system's progress. Even if the United States continues its vigorous support of liberalization at the WTO, the system faces tremendous challenges. Without such support, progress is hard to imagine and the prospect of decay is very real.

The leading governments of the world seem to have recognized this peril. At the G20 meeting in Washington in November 2008 and again at the APEC meeting in Peru that December, leaders warned against protectionism and called for progress in trade talks. That progress never came.

It was against this backdrop that the Buy American provision of the American Recovery and Reinvestment Act of 2009 was so ill-received.[7] There are any number of arguments that have been made in defense of this provision: it addresses spending, not trade barriers; there are similar provisions existing in U.S. law; it was amended so as to honor U.S. obligations under international agreements. Yet the signal it sent to the world was that the United States was turning toward protectionism. Even in the early days of a much-heralded new Administration, this provision drew strong complaints from major trading allies such as Europe, Canada, Japan, and Australia.The intent of the provision – to divert demand away from foreign producers and protect domestic producers from competition – was an old and familiar one. The sentiment is by no means unique to the United States, but by succumbing to it, we seemed to be abdicating our long-held position of global leadership in international trade.[8]

This occurred as the crisis called into question the U.S. model of openness. Countries such as Russia and China that have taken distinctly less open approaches in both economics and governance have cited the crisis as evidence of U.S. failure. There is an eagerness to deride a system that relies more on economic liberty and individual initiative.[9]

Such analysis is premature. The United States had a housing bubble. So did others. There was financial malfeasance and some major institutions made some very unwise bets. The financial crisis hit countries with differing levels of regulation and with differing financial structures. None of this should diminish the fact that the United States' open market approach has been an engine of growth, innovation, and employment for many decades. [10]

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[7] P.L. 111-5, Section 1605.

[8] This impression was not due to 'Buy American' alone; the expiration of U.S. trade negotiating authority and the failure to pass trade agreements with Panama, Colombia, and South Korea in 2008 contributed as well.

[9] See Marc Champion and Andrew Batson, "Russia, China Blame Woes on Capitalism," *Wall Street Journal*, January 29, 2009, p. A6.

[10] Globally there is a long history linking openness with growth as well. See Jeffrey D. Sachs and Andrew Warner, "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity*, 1995:1, pp. 1-95.

At the risk of oversimplification, let me suggest an analogy: The United States economy is like a great prizefighter. At a critical moment, it dropped its guard, took a heavy blow, and lost a big fight. Nursing our wounds, we might draw a lesson: “keep your guard up!” Instead, it is as if we are asking whether it makes sense to eat well or pursue a training regimen any more, given that those practices also preceded the loss.

However misguided the analysis, the facile conclusion that U.S. market-oriented policies are to blame for the crisis has served to undermine U.S. global economic leadership. Going forward, if sound policies are rejected along with genuinely flawed approaches, there could be a large future cost to pay for both the United States and our allies in terms of foregone prosperity.

3. Global Economic Strains Still to Come

Countries have only begun to adopt policies in response to the global crisis. These policies are likely to stoke new global tensions in a number of diverse areas. U.S. foreign economic policy will need to contend with this changed landscape.

Borrowing

One of the most striking results of the crisis has been a reshuffling of international capital flows. For a number of years, the United States has been a major borrower on international capital markets while countries in the Middle East, Japan, and China were significant net providers of funds. With plunging oil prices and Japan’s economic difficulties, China has been left as the major net creditor. Meanwhile, the dollar rose and Treasury yields dove as investors rushed to the perceived safety of U.S. government debt.

For the time being, this has meant that the United States can contemplate borrowing trillions of dollars without too much concern about its ability to raise the funds. Even so, interest rates on 10-year U.S. debt have risen significantly off their lows and the credit default swap market has begun to show a realistic chance of a future U.S. default.

In the present, there are three things to note about this rapid accumulation of debt. First, it works because the private sector is dormant. When the private sector revives, there will be more competition for funds. Second, it already has the effect of crowding out developing nations, who are eager but unable to borrow. Third, it will require some serious rethinking of our demands on China. The argument that China manipulates its currency has been a mainstay of economic policy criticism for years. China prevents its currency from appreciating in large part by buying foreign debt instruments. If we care about consistency, we cannot simultaneously criticize China for distorting its currency and encourage the Chinese to buy Treasury debt, as Secretary Clinton did on her recent visit to Beijing.

In the longer run, excessive accumulation of debt in the United States raises serious risks. The most worrisome scenario is that other nations would lose faith in the United States’ ability to pay off its debt and would sell Treasury debt. This would threaten the value of the dollar, raise interest rates, stifle growth, and raise debt servicing costs. It also poses the risk of large capital losses for countries with large U.S. debt holdings. One impolitic Chinese financial official was recently quoted as saying of the United States:

"We hate you guys... Once you start issuing $1-$2 trillion (in debt) ... we know the dollar is going to depreciate, so we hate you guys, but there is nothing much we can do."[11]

Subsidies

The world trading system has had a difficult time dealing with the effects of subsidies. While explicit export subsidies have been banned, it has been much harder to reach consensus on support that affects trade indirectly. This has led to some very high-profile conflicts in the past, such as the dispute between the United States and the European Union over assistance to large passenger aircraft makers Boeing and Airbus. It also has been a staple of U.S. complaints about China, as U.S. producers have argued that Chinese government policies have unfairly distorted prices.

The current economic crisis response has brought significantly expanded government involvement in new sectors of the economy. Perhaps the most prominent example in the United States was the Bush Administration's decision to provide financial support for General Motors and Chrysler.[12] These companies have global operations and have often performed better in foreign markets than they have domestically. We should not be surprised when foreign governments begin to argue that they are facing unfair competition from government-subsidized American firms.

This problem will not be confined to the auto sector. The U.S. government's involvement in financially supporting alternative energy development has already drawn a trade response. On March 3 the European Council of Ministers approved tariffs on U.S. biodiesel in response to U.S. subsidies.[13] With expanded support for alternative energy, such disputes are likely to proliferate in coming years.

Beyond sectoral support, there will be issues concerning government support of the financial sector. This support has both direct and indirect effects on trade. There is vigorous global competition in financial services. In a time of uncertainty over the viability of financial institutions, government backing can serve as a major advantage in attracting business. This is certain to draw complaints from competitors. Further, an oft-stated goal of financial sector support in the United States is to stimulate new lending. While this is an entirely understandable goal in times of economic crisis, it will raise questions of whether loan recipients who engage in international trade are benefiting from subsidized credit.

Regulation

There is also likely to be conflict over the extent and nature of regulation. In fact, this conflict seems to be on the agenda for the upcoming meeting of the Group of 20 nations in London next month. Some global leaders, particularly in Europe, have long favored expanded regulation of entities such as hedge funds. The crisis has provided an

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[11] Henny Sender, "China to Stick with U.S. bonds," *Financial Times*, February 11, 2009.
[12] See Philip I. Levy and Michael O. Moore, "Driving Toward a Trade War," *American.com*, February 19, 2009.
[13] "EU Clears Way for Antidumping, Antisubsidy Duties on U.S. Biodiesel," *Inside U.S. Trade,* March 3, 2009.

opportunity to push this remedy, even in the absence of evidence that these lightly-regulated entities played a role in causing the crisis.[14]

This would seem to be a particularly unpromising area for cooperation. There are important differences among the G20 nations in the configurations of their financial sectors. A solution that works well for a bank-dependent economy may not work for an economy that relies heavily on non-bank financial institutions, such as the United States. There seems to be neither an economic nor a political consensus on the appropriate degree of financial regulation. With too little financial regulation, institutions can run amok. With too much, we can stifle the driving force of economic progress.

Even seemingly innocuous policy planks like a call for increased transparency can be fraught with difficulties. The very announcement that a major financial institution is in a perilous state can precipitate a crisis. This is likely one reason that the Obama Administration is not conducting its bank "stress tests" in the public eye.

4. Policy Options

It is not clear that the G20 is the appropriate forum for reconfiguring the global financial system nor that the time is right for doing so. The crisis today looks quite different than it did six months ago. It may look different six months hence. Before undertaking far-reaching measures, we should begin with a clear diagnosis of the current system's failings. It may not be possible to do that until the crisis has further played itself out.

There is an important need for global coordination, but it is not clear that this need is best met through large-group summitry. The challenges are sufficiently great and the subject matter sufficiently intricate that this requires substantial quiet economic diplomacy. This makes it all the more important that the Administration quickly work to fill the positions in the subcabinet. As to the country grouping, while it is important to maintain an ongoing dialogue with China about economic concerns, it will also prove much easier to work through these issues among a smaller group of like-minded major economies.

The critical U.S. policy measure that surpasses all others in importance is a decisive approach to resolving the difficulties of our financial institutions. Without such a resolution, it is exceedingly unlikely that any package of fiscal stimuli, regulatory measures, or long-run investments will do much good. With such a resolution, we will be able to rely once again upon the most proven stabilization tool in our economic arsenal – monetary policy. There are a number of approaches that could be taken to fixing the financial sector and there are obvious political pitfalls to many of them. As you work your way through these thickets, I would emphasize one distinction that has often been neglected in these discussions. It is *not* essential that existing investors and management on Wall Street be bailed out. It *is* essential that we have a well-functioning financial system. It is possible to have one without the other.

Given the dangers described above, it is also imperative that we pursue fiscally responsible policies as we move beyond the crisis. This is not to argue for budget cuts in the midst of a sharp recession. Rather, we must convince both a domestic and an

[14] For a skeptical view of the role of deregulation in the crisis, see Peter J. Wallison, "The True Origins of this Financial Crisis," *American Spectator*, February 2009.

international audience that the United States will be able to pay its bills as we move beyond the crisis.

Compared to these other policies, the recommendation that the United States continues to push for open markets appears relatively easy. Public concerns about growing inequality are legitimate. Economic studies have shown that the primary drivers of inequality and wage stagnation are differing returns to education and the changes wrought by new technology.[15] We do the country a disservice if we ignore the economic evidence and falsely attribute all of these ills to international trade.

If the United States leads the way toward open markets in goods and services, through its words and its actions, it will help restore confidence in the global economy and it will help create future prosperity at home.

[15] See Robert Z. Lawrence, Blue-Collar Blues: Is Trade to Blame for Rising U.S. Income Inequality?, Peterson Institute, January 2008; and Claudia Goldin and Lawrence F. Katz, The Race Between Education and Technology, Harvard, 2008.