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New policy advice: Dealing with the downside risks of trade

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The G20 meeting in Hamburg concluded not only with an endorsement of free trade, but also with the resolution to share best practices of how to deal with trade adjustment costs. It seems likely that if there were a silver bullet to deal with the downside risks of trade, we would have already found it. Instead, there are only country-specific solutions. But what are those policies that can help mitigate the adverse effects of trade? This blog post reviews recent contributions to this question.

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1 No silver bullet

The European Union (EU) has positioned itself as a strong advocate of free trade in the past year with CETA, the free trade agreement with Canada, and a new agreement with Japan in the pipeline. At the same time, the EU has also emphasised its role as an advocate for a more socially-balanced trade policy. By contrast, the US government has called for fairer trade rules and threatened to impose protectionist measures.

Despite some disagreement, the G20 Leaders' Declaration, which concluded the summit in Hamburg in July 2017, did not only endorse free trade and the importance of fair trade principles, it also pointed to the difficulties of sharing the benefits of trade and coping with trade adjustment costs. The heads of states agreed to exchange information on best practices. Two recent publications look at concrete policy measures to mitigate these costs:

First, the International Monetary Fund (IMF), the World Bank (WB) and the World Trade Organization (WTO) argued in a joint report called "Making Trade an Engine of Growth for All" that there is no one-size-fits–all solution when it comes to coping with the costs of trade adjustment. Instead, they hold that there are only country-specific solutions in this report presented in April 2017. Second, the European Commission has published its take on how the EU should respond to globalisation in a paper entitled "Harnessing Globalisation", which, as part of its reflection paper series, was published in May 2017. In this blog post I look at advice for national governments only (not general trade policy recommendations): What do the two publications propose?

2 What governments could do

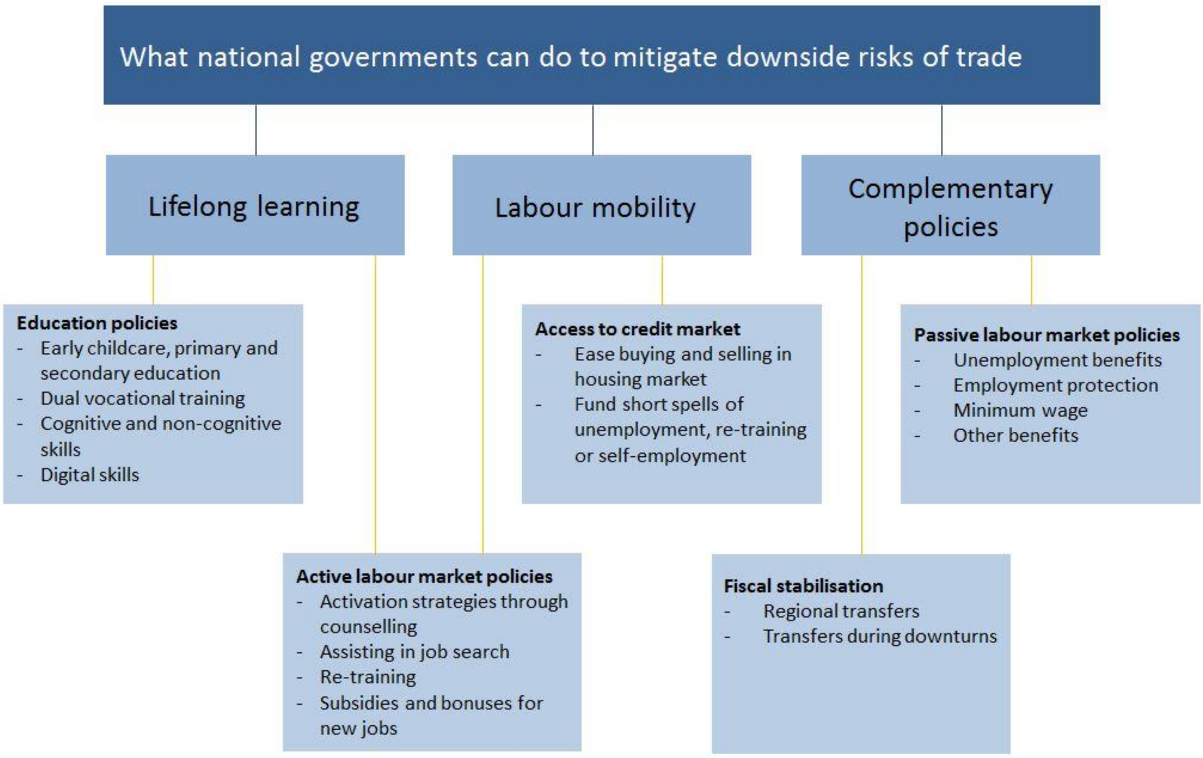
To start with, the IMF/WB/WTO and the European Commission identify different priorities. While the former points out that **labour mobility**, especially geographic mobility, is the key to mitigating adverse effects of trade integration, the latter puts the emphasise on **lifelong learning**.

For labour mobility, the priority of the IMF/WB/WTO, there are two important policy areas: **access to credit markets** and **active labour market policies** (ALMPs). The first matters, as the publication argues, because a functioning mortgage market is essential for buying and selling houses. Evidence from the US suggests that during the mortgage crisis labour mobility plummeted as homeowners could not sell their houses without losing money. Likewise many found it difficult to obtain a mortgage for buying a new place. ALMPs can also help to increase labour mobility for instance by increasing the matching rate through individual counselling or offering re-training to allow job seekers to move from a declining sector to a new one.

ALMPs also matter for lifelong learning, the key priority of the European Commission. As older job seekers might not know which new sectors might require similar skills that they already have, individual mentoring might help them find a suitable job (this is a point also made by the IMF/WB/WTO). The second pillar consists of **education policies**, ranging from early childcare provision to dual vocational training, as the European Commission outlines. Here, the emphasis is on skill composition: soft skills have become more important in many professions and so have digital skills.

In addition, both publications advocate **complementary policies** to reduce possible negative effects on individual incomes and on regional budgets. The IMF/WB/WTO call them passive labour market policies. They include income smoothing measures such as unemployment benefits. Minimum wage legislation can prevent a race to the bottom especially in the low-skilled sector, as the IMF/WB/WTO point out. **Fiscal stabilization** measures entail permanent transfers from prospering regions to structurally weak regions, and temporary fiscal transfers during a recession to stabilize the local economy. The figure below provides an overview of the key recommendations from both publications.

Fig. 1: Overview of recent policy advice on how to deal with downside risks of trade



Source: Author's summary of IMF/WB/WTO (2017) and European Commission (2017).

3 The value added of this new advice

None of the reform ideas is strictly speaking new. They are similar in spirit and content to the country-specific recommendations (CSRs) the European Commission publishes during the European Semester or the structural reforms that the OECD or the IMF advocate. The implementation record of the CSRs has been rather disappointing, as I have argued elsewhere. And the wish list above might await a similar fate.

Still, there are two good reasons not to ignore the policy advice: First, the insights that there is no silver bullet and that there can only be country-specific solutions help to recall that very different economic structures can produce similar outcomes. For instance, the unemployment rate in many liberal market economies is as low as in the Scandinavian welfare states. (Arguably, other outcomes differ markedly, such as inequality.) Even if empirical evidence suggests that job losses in the low-skill segment and the industrial sector have been largest across all countries, both publications refrain from generalized advice and recognize the importance of pre-conditions.

Second, while the reflection paper by the European Commission is rather cautious when it comes to actual recommendations that could be implemented at the national level, the reform recommendations by the IMF/WB/WTO are explicit, and also point to potential trade-offs. For instance, ALMPs can also have disrupting effects: On the one hand, they can lead to endless re-training programs without a re-integration into the labour market. On the other hand, if there are incentives to enter the labour market as quickly as possible, like bonus payments for finding a new position, job seekers might invest too little time in retraining and end up in low-skilled and low-paid positions. It is worth recalling that no reform recommendation comes without a caveat.