THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

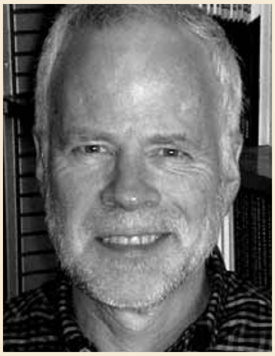
Collapse in World Trade

World trade has been collapsing faster than global GDP—indeed, faster than at any time since the Great Depression. How is this possible?

Look at prices and volume.

GARY CLYDE HUFBAUER
Reginald Jones Senior Fellow, Peterson Institute for International Economics

The collapse in world trade has been spectacular. Fortunately the demons of 2009 are not yet spinning Kindleberger's infamous cobweb of the 1930s. There is too much new protection in the world economy—more than one hundred episodes since the financial crisis erupted—but so far the measures are pinpricks, not hammer blows. The two reasons why developing country nominal exports are down around 20 percent since the middle of 2008 are prices and volume, each about half the story. Commodity prices are always a shock absorber, and in this crisis the shock has been terrific. Export volumes are down mainly because developing country exports are concentrated in consumer goods, the economic segment where demand contraction is severe, and the segment where vertical supply chains across multiple borders, meaning that a drop in final demand of $100 can cause trade to drop by $200 or more. The OECD countries are doing better than the developing countries, since (with a few exceptions, like Canada and Australia) commodity prices are not a major factor in their export sales. But again, export volumes are down sharply, particularly for autos and other consumer durables. Any country that sees its exports drop less than 7 percent in 2009 can count itself lucky.

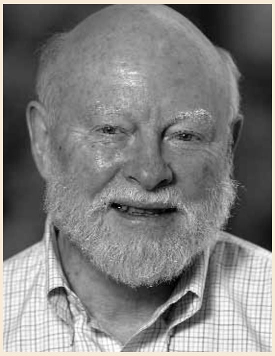


The growth of supply chains has magnified the impact of declining final demand on trade.

BARRY EICHENGREEN
Professor of Economics and Political Science, University of California, Berkeley

The collapse of trade since the summer of 2008 has been absolutely terrifying, more so insofar as we lack an adequate understanding of its causes. Murky protectionism has played a role. Disruptions to the supply of trade credit from international banks in particular have negatively impacted some countries. The most important factor is probably the growth of global supply chains, which has magnified the impact of declining final demand on trade. When a U.S. household decides not to buy a $40,000 Cayenne sport utility vehicle from Germany, German exports to the United States go down by $40,000, but Slovakian exports to Germany go down by perhaps half that amount, since while the final assembly is done in Leipzig, the coachwork is done in Bratislava. All this said, it really is the case that we don't fully understand the relative importance of the effects.

If it is any consolation, there are signs that trade will rise with recovery every bit as fast as it fell with the onset of the crisis.



The reasons are subtle.

RONALD I. MCKINNON
Emeritus Professor of Economics, Stanford University

After decades when international trade grew much faster than GDPs, it fell by 6 percent in 2008. In 2009, the International Monetary Fund projects a decline in international trade of as much as 12 percent in comparison to "just" 6 percent declines in industrial output and 2.5 percent in per capita incomes. Particularly hard-hit are countries heavily dependent on exports of manufactures—the larger ones being China, Germany, and Japan.

The worldwide cyclical downturn originated with the credit crunch and banking crisis from the collapse of the U.S. housing bubble, which itself is not particularly related to international trade. So why should international trade be hit so hard?

First, world trade is very intensive in manufactures. And purchases of durable goods are most easily postponed when peoples' incomes fall and they feel less secure.

Second, and more subtly, international trade is more vulnerable to the credit crisis and associated counterparty risk than is purely domestic transacting. The use of formal bank letters of credit has long been much more common in foreign trade than in domestic trade, and these are designed to facilitate normal trade credit from exporter to importer—when the foreign importer may not be as well known to the domestic exporter, for example, the natural counterparty risk is high. But if the solvency of the bank providing the letter of credit becomes suspect, then this risk-reducing mechanism breaks down.

Even more subtly, the impairment of the foreign and domestic interbank markets at wholesale (from bank counterparty risk), makes forward exchange transacting more difficult and expensive—particularly at medium to longer terms to maturity. Thus, at retail, importers or exporters find it more difficult to hedge themselves from currency fluctuations. Without forward cover, they find it even harder to secure credible bank letters of credit. It becomes all the more important for governments to keep exchange rates stable, as China has since last July.

Government export-import banks are the natural agencies to step up and provide much more trade credit. But despite frenetic efforts of many of them to do so, they were too late to prevent the severe downturn in world trade. Yet they must continue to intervene massively if the system is to recover.

An important factor: the drying up of financial credit.

JAGDISH BHAGWATI
University Professor, Columbia University, and Senior Fellow in International Economics, Council on Foreign Relations

Trade has been growing faster than GNP for quite some time before the current crisis, as reflected in growing ratios of trade to GNP in most countries. It would therefore appear to be a matter of symmetry for the collapse in GNP to lead to a greater collapse of world trade. But more needs to be said.

Trade tends to grow faster than GNP because it reflects growth of GNP as well as reduced trade barriers at any level of GNP. During the downturn, there is no evidence that trade protectionism has yet grown to dramatic levels, though no complacency is justified about what could happen if we do not confront the protectionist pressures that are building up. However, an important new contributory factor on the downside is that we have not just a Main Street crisis but also a Wall Street crisis, and the drying up of financial credit has further harmed trade. (The WTO-inspired demand that special finance be provided to facilitate trade, which has led to successful action following the G20 conferences, is therefore a welcome development.)

One fallacy must be dismissed, however. In an exchange with Naomi Klein, who is a fount of many economic fallacies (underlining how economics is a difficult subject with excessive free entry by the ignorant), she was celebrating the growing demise of "globalization" because higher energy costs had become a tax on transportation and hence on trade. I pointed out that higher fuel costs would affect production costs of traded goods as well; and if the differential in production costs of traded goods between the exporting and the importing countries widened, that could offset the increased transportation costs and serve to increase, not diminish, trade.

When times are tough, we find ways to make them worse.

WILLIAM E. BROCK
Former U.S. Trade Representative, and former U.S. Secretary of Labor

For much of the post-war period, world trade has grown far faster than global GDP, as income, technology and productivity gains magnified the gains enabled by reductions in domestic barriers to trade and the creation of a World Trade Organization. When events lead to deepening recessions in the majority of nations, there is less money available for investment, less capital to finance new technologies and greater production domestically, and less financing for exports or imports. Thus the effect on trade between nations occurs far more quickly, and with far more impact than it does within individual countries. That alone would be bad enough, but clearly other factors have contributed much to our collective travails.

Especially in a time of domestic recession, many political leaders find the old habits of protectionism almost irresistible. It takes courage for politicians in nations with elected governments to resist the temptation to excuse their nation's lack of growth by faulting others, and that courage has been in short supply—especially in the leading nation in the world.

A "Buy American" amendment was attached to stimulus legislation recently. Newspapers across the country are already noting the especially pernicious effects these egregious actions are having on our closest neighbor and largest trading partner, Canada. If the mighty United States can engage in abusive actions against its most important economic partners, why should not other countries emulate the leader? Most know that such acts will prove counterproductive for the majority of our people, but still they lack the political will to put the nation first.

In so many words, when times are tough, far too many finds ways to make them worse. This, then, is a large part of the answer to the question as to why world trade has been collapsing faster than world GDP.

The reason is that the U.S. consumer is pulling back.

TADASHI NAKAMAE

President, Nakamae International Economic Research

World trade is collapsing as consumers in the United States, who had been spending beyond their means, are paying their debts, essentially saving more than they used to. The era of over-consumption by Americans, which propelled world trade growth for so many years, is over. While globalization and technological advances to supply chains have made all countries more dependent on trade, this has had a much smaller impact on global GDP. The differing degree of this impact on global GDP and world trade explains why it has caused the latter to drop at a faster clip.

Resources, from raw materials to workers, are scattered around the globe, and technology, particularly in the supply-chain network, has enabled industries to take advantage of this, a big difference from the 1930s. Trade is no longer a simple transaction between two countries. It now involves an intricate network of countries, each contributing a different part or process in the making of a finished product. All this multiplies the amount of global exports needed to complete the transaction of one finished product. When consumption falls and there is less to produce, the process reverses and thus world trade falls faster than global GDP.

China's growing role in world trade illustrates this point. When the U.S. economy was booming, growing consumption led to greater imports because the United States did not increase production. Rather, it relied on cheaper supply from Asia, thus raising its dependency on imports. Japanese companies (among others) exploited this by building factories in China to take advantage of cheaper wages. Japan exported capital goods to China (trade) for the construction of factories, and then exported components (trade) to those factories for Chinese workers to assemble finished goods to be exported to U.S. consumers (trade again). The value added in China represented a portion, perhaps 50 percent, of the total value of its exports to the United States. Had Japanese companies produced everything at home and exported finished goods to the United States, the value of Japanese exports would have been the same as the value of Chinese exports to the United States, but total trade would have decreased by the value of capital goods and components no longer shipped from Japan to China.

Meanwhile, in China, new factories created employment, while production and exports increased, leading to bigger trade surpluses. As its economic growth accelerated and domestic liquidity increased, China invested heavily in infrastructure and real-estate projects. These consumed large amounts of raw materials which China imported from resource-rich countries. Not so now that the global economic climate has changed. World trade is collapsing rapidly because American consumers are not spending, spreading large ripples across the globe.

The culprit: global supply chains.

SYLVIA OSTRY
Distinguished Research Fellow, Munk Centre for International Studies, University of Toronto, and former Canadian Deputy Minister for International Trade

The recent decline in world trade at a rate outpacing the fall in production has attracted a great deal of attention. As the World Trade Organization released its forecast for 2009, Director-General Pascal Lamy noted that for the past three decades trade has usually grown faster than output.

Several reasons are provided for this new development: a recession that is very widespread, a shortage of trade finance, and a rise in protection. This sounds sensible enough, but at present unlikely to account for the 9 percent fall in export volume—or the OECD's 13.2 percent "collapse"! So another factor must be at play: global supply chains. As the WTO notes, goods cross borders many times. The "global corporation" is not the hierarchical static pyramid of the past but a new complex multi-country company with a strategy of integrated global production and delivery. The supply chain is key to the ongoing objective of global integration. This is part of the Great Transformation, engendered by the information and communication technology revolution. But this revolution and its impact on the corporation is not a creation of the twenty-first century. We have no birth date of the new corporation, but we know intra-firm trade began in the 1970s and the revolution in information and communication technology began in the mid-1990s.

I'm not arguing that the supply chains are not relevant to the decline in trade. I don't know. For me the issue is that nobody knows. We have a new trading system and no data. When Canada ships component parts of widgets across the border we don't know where they're going and if or when they're returning. Container ships entering Vancouver have lousy manifests with goods from where going to where? So it's very alarming that trade is falling so quickly. Why? We don't have the information to answer that alarming question.

My point is that we must get a project (WTO, OECD, UNCTAD) to start a new statistical system. At Cambridge Keynes was instrumental in the project to define and measure GDP. To know why trade is falling or rising or whatever, we must have a new statistical system.

Look to trade financing and the global supply train.

MARINA V. N. WHITMAN
Professor of Business Administration and Public Policy, University of Michigan, and former member, President's Council of Economic Advisers

World trade has been collapsing faster than at any time since the Great Depression because global output has been doing the same (with the exception of the World War II years). More interesting is the question of why world trade is collapsing even faster than global output. I believe there are at least two explanations, one real and one arising from the way these entities are measured.

Assuming that the relevant marginal propensities are not very different from one another at the global level, one would expect the vicious circle between declining output and declining trade to pull both down at about the same pace. But trade has been hit by a double whammy, with a severe pull-back in financing added to—and interacting with—the global recession. Some 90 percent of merchandise trade is dependent on trade finance. Although production also requires a degree of external financing, its dependence is far less than in the case of trade. The result is that when financing seizes up, trade responds more sharply than output.

Furthermore, more and more firms have created global supply chains, using facilities in different countries for different stages of the production process, from raw materials to intermediate goods to final products. Such intra-firm trade is likely to be double or triple counted as it crosses multiple national borders, while GDP is calculated on a value-added basis. Thus, the technicalities of how global output and trade are measured add another reason why movements in trade are likely to be magnified as compared to movements in output, whether upward or downward.

Finally, much has been written about how the global downturn is creating more protectionism or economic nationalism as regards both trade and finance. But, although I have no hard numbers, my guess is that protectionist measures have so far had far less impact on the decline of trade than the other factors I've mentioned.

Look at the nature of the preceding boom.

BERNARD CONNOLLY
Managing Director, Connolly Global Macro Advisers

The trade collapse in the months following Lehman had several sources. Protectionist measures, overt or covert, were one. Reduced trade finance was another. But most important was the nature of the preceding boom. The boom reflected intertemporal misallocation, bringing dynamic inefficiency, asset-price (and notably credit) booms, and macro Ponzi games (notably European monetary union). This had two effects. First, too much spending was brought forward from the future in the world as a whole. That was possible at a world level because central banks' inflation targeting in response to globalization and technological improvements prevented a faster disinflation of prices, temporarily squeezing real wages, pushing unemployment below its long-run "natural" rate, and global output above its "natural" rate. Second, the misallocation was greater in some countries than in others, producing a widening of current account deficits, and corresponding surpluses elsewhere. It was thus inevitable that when the credit bubble collapsed, and Ponzi games partly collapsed with it, world trade would be particularly badly affected.

In principle, non-traded goods and services can be affected by a bringing forward of spending (and by a subsequent collapse) as much as traded goods and services. But in practice, the bringing-forward of spending principally takes the form of purchases of durables, whether producer durables or consumer durables (including houses). Residential construction materials, capital equipment, and consumer durables are heavily traded. Thus the impact of the boom, and subsequent collapse, on world trade was magnified further. Dramatic rates of decline in capital formation and purchases of consumer durables, such as cars, were inevitable once the boom collapsed. So was rapid destocking. And in consequence world trade fell more rapidly than output. But one should not be surprised to see, if and when the inventory cycle turns for a while (as it may have done), a temporary recovery in world trade.

The key is to expand domestic demand.

C. FRED BERGSTEN
Director, Peterson Institute for International Economics

World trade has been rising much faster than the world economy for the past five decades. Trade has expanded by an average annual rate of 11 percent since 1957 as opposed to 4 percent growth for global output, a positive ratio of about 3:1.

It should thus be no surprise that trade has declined faster than world growth. The latter has been falling at an annual rate of about 6 percent over the past two quarters. Trade has apparently dropped at an annual rate of about 24 percent over the same period, a ratio of 4:1 that is not much different from the earlier period.

The trade decline has of course reinforced the growth downturn, especially in export-dependent economies ranging in size from Japan to Singapore. Renewed expansion of domestic demand in these and other countries, however, should arrest both their macroeconomic slides and the trade trends themselves. A renewed spurt in trade growth may be one of the upside surprises of late 2009–early 2010 and an important contributor to world recovery.

Policy needs to reinforce this prospect in at least two dimensions. First, all countries—notably the G20 but others as well—must honor the G20 pledges at both Washington and London to avoid new protectionist measures.

This must include those that are technically "legal," under the rules of the World Trade Organization and other trade agreements, and those that are trade-expanding (like export subsidies) as well as trade-contracting. All countries must also respect the G20 commitment at its second summit to avoid competitive currency devaluations to try to export their way out of the crisis.

Second, policy needs to correct the still-large global trade and current account imbalances. The financing of the U.S. deficit, by China and other large surplus countries, created much easier monetary conditions in the United States and thus encouraged the overleveraging and underpricing of risk that brought on the current crisis. China's global surplus will approximate the U.S. global deficit in 2009, so sizable appreciation of its substantially undervalued currency by about 20 percent on a trade-weighted basis, including 40 percent against the dollar to less than ¥5 RMB per dollar, is more necessary than ever.

Here are several reasons.

ANDREW SZAMOSSZEGI
Managing Consultant, Capital Trade

There are several reasons why international trade has collapsed faster than global GDP. First, the decline in manufacturing output has exceeded the decline in real GDP. For example, U.S. industrial production in the first quarter of 2009 was 14 percent lower than its peak in the fourth quarter of 2007. In contrast, the level of real GDP in the United States in the first quarter of 2009 was only 3.2 percent below its peak. Demand for tradable goods is largely derived from demand for manufactured goods, so the collapse in trade reflects the collapse in manufacturing. Second, the decline in global trade has been exacerbated by business efforts to conserve cash rather than build up inventories to prior levels. Trade flows are being buffeted not only by a general decline in activity, but also by this temporary move to lower inventories. Third, the decline in trade reflects the crisis in finance. Credit plays a critical role in international trade, and the disruption in global credit markets has restricted flows of credit needed to support trade. Finally, the boom in commodities-related trade has been replaced by gloom. Prices for many commodities are falling and ports are packed with imports (think Houston and oil-country tubular goods) for which there is currently limited demand. This new reality is forcing even hyperactive exporters to cut back shipments dramatically.

We had close to a perfect storm.

CLAYTON YEUTTER
Senior Advisor, Hogan & Hartson, LLP, former U.S. Trade Representative, former U.S. Secretary of Agriculture, and former CEO, Chicago Mercantile Exchange

It may not be a perfect storm, but it'll come close! Among the factors present in the current collapse in world trade:

Demand fell off a cliff—consumers stopped buying, and so did businesses. This was not a surprising reaction to a recession labeled as the worst since the 1930s. Business firms generally benefit by market diversification, but not this time. With demand declining everywhere, there is a natural tendency for firms to concentrate on their home markets.

The credit crunch hit hard. In this recession, lenders have been under as much stress as borrowers. Under such circumstances they become very conservative; some might say inordinately conservative. And they're sometimes parochial, so they constrict credit even more for importers and exporters than they do for firms operating exclusively in the domestic economy.

Trading patterns were disrupted by shifting exchange rates. The Wall Street debacle was perplexing and frightening to trade participants. They couldn't predict the final outcome, and they didn't know where that would leave exchange-rate relationships. Their only recourse was to flee to safety. That gave the dollar a boost, and forced business firms everywhere (and their creditors) to adjust. Risk, uncertainty, and rising volatility: those are prescriptions for a pullback in commerce.

Governments asserted themselves, for good and for ill. Stimulus packages emerged in the United States and elsewhere, and some of those provisions will benefit global commerce. But our government, and others, could not resist the temptation to enact "Buy National" laws, all of which are beggar-thy-neighbor in effect. Those laws neutralize each other, everybody loses, trade shrinks, and jobs disappear.

A stagnant Doha Round has been an albatross around everyone's neck. When a trade round is going nowhere at the same time that economies are faltering, the psychology is terribly negative. Developing countries in particular were hopeful that the Doha Round would open up new market opportunities for them. When those opportunities seem far off, and existing markets are collapsing, a pullback in international commerce is inevitable.

Business firms responded rationally, contributing to the downward spiral. When business firms face a 15 or 20 percent decline in demand, they cannot just sit tight. They must cut costs, often dramatically. That typically leads to major layoffs, declining consumer confidence, and further reductions in consumer demand. In manufacturing it also leads to pressure on suppliers, and foreign firms (particularly where transportation costs are significant) are often the first to be cut. These are all sensible responses to a challenging situation, but they reverberate throughout the global economy. The downward spiral continues, production declines, and trade is further constricted.

The main culprit: a globally synchronized downturn.

NORBERT WALTER
Chief Economist, Deutsche Bank Group

The world economy is undergoing its deepest recession since World War II. The volume of global trade in goods and services is down by more than 10 percent in 2009, year over year. While such a steep downturn is unprecedented, it was always the case that trade had a multiplier of more than two compared to GDP.

World trade has fallen off the cliff for several reasons. First and probably most important, the current economic crisis is hitting countries all over at the same time. This synchronized global downturn could only happen because of the many coinciding causes: excesses in real estate, construction, financial markets, stock building, and conspicuous consumption and investment with low internal rates of return. With the real estate bubble having imploded—including in places where people thought there was infinite wealth and the sky was the only limit for skyscrapers—the demand for both commodities and investment goods has declined sharply. As international trade is one of the most important transmission mechanisms, it was not surprising that trade figures imploded. Furthermore, the decoupling of emerging markets has not materialized. BRIC states in particular are suffering from lower growth rates with huge effects on the volume of their exports of industrial and agricultural commodities.

Second, due to the astonishing increase in commodity prices during 2007 and 2008, companies pursued a strategy of massive inventory accumulation. This further heated up global trade volume. As soon as the crisis began, companies started destocking, creating a massive downturn in trade.

Finally, the negative effects of the international financial crisis, which had taken a dramatic turn for the worse following the collapse of Lehman Brothers in mid-September 2008, almost brought money markets and the markets for short-term corporate credit to a standstill. This restricted the ability of corporations to carry out investment plans and thus accelerated the decline in global trade volume via a further decrease in imports of resources and exports of investment goods.

The trade shock is the result of the financial crisis.

NICOLAS VÉRON
Research Fellow, Bruegel

The collapse in trade mirrors the financial collapse. It has been concentrated in goods whose purchase is based on an investment process that requires visibility about the future and often external financing as well, such as capital goods and cars. Thus, the trade shock is a direct consequence of the events that wrecked the financial system in September-October 2008. In retrospect, it is unsurprising that its magnitude was unprecedented since the 1940s, as this is also the case with the financial shock.

The financial crisis has been framed by some commentators as evidence of disconnect between the "financial sphere" and the "real economy." But the collapse in world trade illustrates exactly the contrary: namely, that finance and trade are so deeply interdependent that it is impossible to consider one without the other. In ancient Rome, a well-known fable had statesman Menenius Agrippa persuading strikers who had retired to the Aventine Hill that plebe and patricians were as indispensable to each other as the stomach and the other parts of the human body. Now, the financial system has failed, and more senior bankers should lose their jobs and privileges than has been the case so far—especially in Europe. But trade needs finance all the while. Political talents such as Menenius Agrippa's are more needed than ever.

The trade downslope is rooted in a complex set of circumstances.

WILLIAM M. CALDWELL IV
Chairman and CEO, Advanced Cell Technology, Inc.

Since the Lehman bankruptcy, manufacturers and retailers have struggled to realign inventory levels as they slash production output in response to drastically reduced consumer demand. One might naively postulate that lack of trade credit, as a component of the world-wide credit crisis, was the major culprit in turning down the trade faucet, thus creating a seemingly steeper worldwide trade reduction when contrasted to the decline in global GDP. However, the trade downslope is rooted in a more complex set of circumstances.

International production sharing or the internationalization of manufacturing supply chains is a major part of the story. Components may be made in one country, assembled into subassemblies in another, turned into finished product in a third and sold in a fourth. This is in contrast to producing the entire product in one country and selling it in a second. When the demand for a product shrinks, the multiple trade flows are terminated; not just the final trade flow. The result is a steeper decline in trade volumes than in recorded manufacturing output. World Bank economists note that the industrial sector has been adversely impacted more than the services sector, which exacerbates this negative multiplier effect on world trade statistics versus world GNP.

The concentration of discretionary goods and services as a larger component of world trade also bears upon the dramatic decrease in international trade. Demand for such items fluctuates greatly which translates into higher export/import volatility than that of the underlying economy. A trend towards greater protectionism has thus far been applied to industries that traditionally demanded protection; but in the future could spread to other industries in countries that desire to protect jobs.

One final observation. The impact of oil price declines during the period from summer 2008 through March 2009 (greater than 50 percent in the fourth quarter of 2008) generated larger price declines in world trade statistics than actual volume declines. This could have a corresponding positive statistical impact if prices continue to rebound during the remainder of this year.

A political narrative hangs over the trade debate.

KEVIN G. NEALER
Principal and Partner, Scowcroft Group

The breathtaking decline in trade has occasioned serious concern. It should. But this contraction can be expected to abate as trade financing has stabilized. So too, with tech product life cycles under two years, firms that delayed technology purchases at the onset of the downturn are now concerned that they are giving up productivity gains to competitors. Pent-up demand could help reverse trade contraction, especially in OECD countries.

But a political narrative hangs over the trade debate. Smoot, Hawley, and Hoover were Republicans, and Ronald Reagan holds the record for dollar value of restrictions imposed on American imports. But editorial boards warn that Team Obama and the Democratic Congress presented a threat to trade growth and the recovery. In fact, the greatest trade-related danger facing the new team was an unscripted fight over Treasury's report on currency manipulation that might have triggered a Sino-U.S. trade war. The decision not to name China as a manipulator seemed to reflect a deliberate Administration choice to reinvent expectations of how the United States and China must cooperate in a changed world economy.

The other genuine trade policy risk evaporated with President Obama's insistence that "Buy America" provisions of the stimulus plan be WTO-compliant.

These may be only two data points, but they are enough to start graphing a new set of expectations about trade risk. Obama still lacks "fast track" trade negotiating authority, and he has made no effort yet to claim time for it in the crowded legislative calendar. Still, actions to date indicate that protectionist risk from Congress is declining, and Obama's ability to manage it increases.

It is premature to make comparisons with the Great Depression.

GREG MASTEL

Senior Adviser, Akin Gump Strauss Hauer & Feld, and former Chief Economist, U.S. Senate Finance Committee

The global recession has sparked a sharp decline in global trade volumes. In fact, the International Monetary Fund predicts a drop in global trade of as much as 11 percent in 2009. Of course, it is not surprising that global recession would dampen global trade. With fewer goods and services being consumed, demand for imports predictably drops.

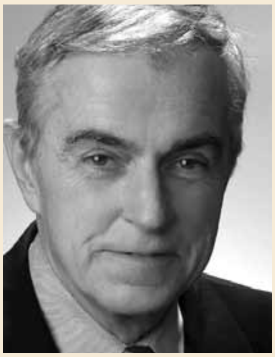
It does seem that trade has contracted even more sharply than general economic activity. In an economic downturn with rising domestic unemployment, inevitably fingers point to imports, a political generalization that applies across most—if not all—countries.

It is premature, however, to liberally make comparisons with the Great Depression. There is little doubt that protectionism in the late 1920s and 1930s at least deepened the Great Depression. The United States' infamous Smoot-Hawley legislation to increase tariffs was an important contributor to the downward spiral.

But things have changed since the Great Depression. There are now global trade rules set by the World Trade Organization that constrain obvious protectionism. It is true that there have been at least superficially troubling developments, including the widely noted Buy American provisions in U.S. economic stimulus legislation. These measures, however, fall well short of being modern versions of Smoot-Hawley.

There is even some reason for cautious optimism. Looming general economic recovery will almost inevitably increase trade. Surprisingly, recent polling by the Pew Charitable Trust suggests that American attitudes toward free trade had actually improved markedly in the last year.

Global trade faces unquestioned challenges. The new round of world trade negotiations—the Doha Round—are drifting and in need of leadership. Efforts to deal with climate change are virtually certain to spark trade and economic conflicts between countries. But international institutions and trading rules have strengthened a great deal in the last century and there seems to be near-consensus among policymakers that protectionism is a mistake. Though the trade challenges are undeniable, there is no reason to panic.



Historical comparisons are difficult.

RICHARD D. ERB

Research Professor, University of Montana, and former Deputy Managing Director, International Monetary Fund

Historical comparisons are analytically and empirically very difficult, especially when the period covered is so short and when all of the relevant data are not yet available. Preliminary data and analyses presented in the April International Monetary Fund *World*

Economic Outlook indicate that many global economic and financial indicators have fallen far more sharply compared to other global recessions over the past fifty years.

The more rapid decline in trade relative to the decline in GDP may be related to a number of factors. For example, the demand for tradable goods generally declines more rapidly than the demand for services during a recession. No doubt the financial collapse during this recession intensified that relationship. Given that the service sector contribution to GDP in most countries is higher than in the past, and given that the share of international trade in the tradable goods sectors of countries has increased over time, it is reasonable to expect that over time declines in international trade would become larger relative to declines in GDP.

There have been reports that countries have imposed explicit and implicit trade restrictions. Whether such restrictions are more stringent this time compared to global recessions over the past fifty years is impossible to say without more evidence. Given the magnitude of this economic collapse I am pleased that countries so far have not resorted to large-scale trade restrictions as occurred during the Great Depression. Of course, politicians and government officials need to continue to resist pressures for trade restrictions.

World trade is elastic.

STEVE H. HANKE
Professor of Applied Economics, Johns Hopkins University, Senior Fellow, Cato Institute, and Contributing Editor, **TIE**

World trade is elastic with respect to global GDP. Accordingly, when global GDP slumps, we should expect an outsized plunge in world trade.

Given the disruption in trade finance that has accompanied the Panic of 2008, we should also expect the current trade plunge to be more pronounced than usual. No surprises here.