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Trade and the Current Crisis

Three new studies explore the sensitivity of trade to changes in income and access to finance

Trade is one of the more visible victims of the current crisis. In the first quarter of 2009, the value of world merchandise trade fell by 30 percent relative to the same period in the preceding year. The volume of trade is estimated to have fallen by over 15 percent during this period with considerable variation across countries and sectors. New World Bank research demonstrates the growing sensitivity of trade to changes in income, the adverse effects of the financial crisis, and the relative resilience of services trade.

The responsiveness of trade to income has risen over time, and tends to be higher during global downturns. Caroline Freund shows that the elasticity of trade to income rose from less than 2 in the 1970s to over 3.5 in recent years. In addition, she finds that during the global recessions that occurred in 1975, 1982, 1991 and 2001, while income growth declined on average by 1.5 percentage points relative to the previous year, real trade declined by nearly five times as much.

The study suggests a number of factors that might be driving these results. Firms may sharply draw down accumulated inventories when the forecast worsens in an unexpected and dramatic way. Also, goods decline more than services during downturns and services make up the bulk of GDP, while goods make up the bulk of trade. Moreover,

the share of services in GDP has increased over time, magnifying this difference.

Financial crises can exacerbate downturns in trade flows through adverse supply-side effects on exporters. Leonardo Iacovone and Veronika Zavacka explore the impact of banking crises on manufacturing in developed and developing countries during 1980–2000. They find that exports of sectors more dependent on external finance were hit harder during a financial crisis than were other sectors, with a 4-percentage-point reduction in export growth vis-à-vis that of sectors less dependent on external finance.

However, this result held only for sectors that relied more heavily on banking finance than on inter-firm finance. Also, sectors characterized by a higher share of tangible assets appeared to be more resilient in the face of a banking crisis because of their ability to raise external resources through higher collateral. Importantly, the study found that the impact of such "supply-side" shocks driven by credit shortages operates independently of negative demand shocks. Moreover, the effect of the latter was over and above that of a banking shock, in particular for sectors exporting durable goods.

Services trade has weathered the crisis much better than goods trade. Ingo Borchert and Aaditya Mattoo examine flows in services trade and show that although demand for services has plummeted, it has been less elastic and thus less cyclical than

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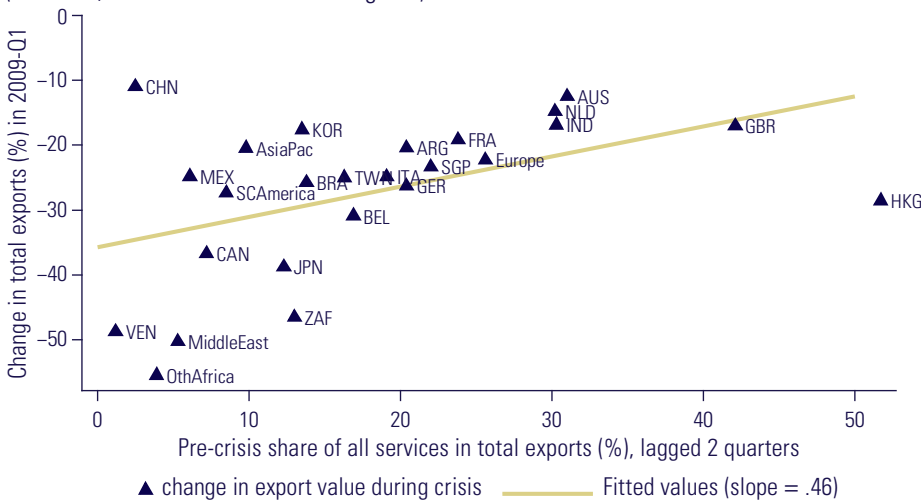
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demand for goods. As of April 2009, US imports of goods were 34 percent lower than a year ago, while exports dropped by 27 percent over the same period. In contrast, imports and exports of services declined by only about 10 percent. Furthermore, trade in business, professional and technical services continued to grow albeit at diminished rates. Finally, exports of countries like India that are relatively more specialized in services have contracted substantially less than exports of countries and regions like Brazil and Africa where services are less important. (See figure 3.)

These results support the claim that slumping demand, destocking of inventories, and financial constraints are the main drivers of trade's dismal performance. Services are not storable

Figure 3. Change in the Value of Exports to the US and Share of Services in Exports (2009-Q1, selected countries and regions)



and are not subject to the inventory effect that has contributed to the rapid fall of merchandise trade flows. Moreover, trade in many business services commonly referred to as "business process outsourcing" is less dependent on external finance, which further insulates services trade from the negative impact of tightening credit conditions.

Caroline Freund. Forthcoming. "The Trade Response to Global Downturns: Historical Evidence." Policy Research Working Paper 5015. World Bank, Washington, DC.
 Leonardo Iacovone and Veronika Zavacka. Forthcoming. "Banking Crises and Exports: Lessons from the Past." Policy Research Working Paper 5016. World Bank, Washington, DC.
 Ingo Borchert and Aaditya Mattoo. 2009. "The Crisis-Resilience of Services Trade." Policy Research Working Paper 4917. World Bank, Washington, DC.

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