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A dramatic fall in world trade could be made much worse by protectionism

AFP

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WORLD trade, the engine of growth, is sinking at a pace not seen since the second world war. In projections released on Monday March 23rd, the WTO predicts that the volume of global trade, which grew by 6% in 2007 and 2% last year, will fall by a dramatic 9% this year. The drop will be worst for rich countries, whose exports will contract by 10%, but even emerging and developing ones, whose exports grew by an average of 15% each year between 2000 and 2008, will see export volumes shrink by 2-3% this year. Before the release of these latest predictions economists had already expected global trade to fall by more than it did in 1982, the last time that it contracted, albeit slightly. Now matters look much worse than they did just a few months ago.

The contrast with the recent past could not be sharper. In the boom years between 1998 and 2008, trade volumes grew at 5.7% per year, easily outstripping the growth rate of world output, which was around 3% over the same period. Now the world is seeing falls in exports that are dizzying and close to universal, and which exceed declines in output. Among the 45 countries for which the World Bank has January trade data, the average fall in exports from a year ago was a staggering 32%, and 37 countries saw exports decline by more than a quarter. The drops cut a wide swathe across the world, with exports plummeting in rich and poor countries alike. Exports from Argentina in January were 36% lower than a year before. The corresponding drop for Canada was 35%. Chile's exports fell by 41%, Japan's fell by 35%.

The immediate reasons are clear enough. The worst recession in living memory means a dramatic collapse in demand for goods everywhere. An estimated shortfall of \$100 billion in trade finance, which is behind roughly 90% of world trade is also making matters worse. Yet the synchronisation

and speed with which exports from countries across the world have plummeted is striking.

Economists believe that an additional reason for these sharp and co-ordinated drops lies in a fundamental change in the nature of global trade over the past three decades, as a result of the rise of global supply chains. When David Ricardo posited that comparative advantage was the basis of trade, he conceived of countries specialising in products, such as wine or cloth. Now, they specialise not so much in final products as in a step, or steps, in the production process, what economists call "vertical specialisation". Vertical specialisation has grown by about 30% and accounts for a third of the growth in trade over the past 20 to 30 years.

Vertical specialisation led trade to grow much faster than it would have otherwise. Earlier, a tractor made in America would use American steel and parts: its only contribution to trade would come if the finished item were exported. Now, that tractor may use steel from India that is stamped and pressed in Mexico, before being exported to Tanzania. Global supply chains have increased the amount of international trade involved in getting a product made and delivered to its final user.

On the flip side, declines in demand that would once have resulted primarily in a fall in domestic output, and would only have had a second-order effect on other countries' exports because of the decline in domestic incomes, now immediately affect trade flows in several countries. The same mechanism that was responsible for the remarkably rapid growth in trade since the early 1980s is now amplifying the extent to which trade responds to a decline in demand, which explains the remarkable synchronisation with which trade is declining everywhere.

More troubling, protectionism is rising and risks making an already severe slump even more catastrophic. When leaders of the G20 countries meet in London on April 2nd they are likely to reiterate a pledge made in November to avoid the mistakes of the 1930s. They are expected to promise to restrain themselves from raising the trade barriers that have been whittled away over decades of tortuous multilateral negotiations. But almost none have kept the promise they made at that last meeting. The World Bank has counted 47 trade-restricting steps taken by 17 of the G20 members. Tariffs have risen in several developing countries, including India, Russia and Ecuador. European ones and America have resorted increasingly to subsidies for failing industries, with implicit pressure on firms to create jobs "at home", possibly at the cost of shutting down more efficient facilities abroad.

An all-out 1930s-style tariff war still seems unlikely, however, partly because existing WTO agreements limit (even if they do not eliminate) the scope for tariff increases. Some also argue that the globalisation of the supply chain has made traditional protectionism, in the form of wholesale tariff increases, more difficult to pull off than in a world where most goods were made with domestic, rather than imported, inputs. This is because taxing imports can end up hurting a country's own producers who rely on imported inputs.

So far, those supply chains seem to be intact, partly helped by the sharp drop in the price of oil. If they survive the crisis, they will help an eventual synchronised recovery in trade. But a further rise in protectionism risks choking off what should be an engine of recovery for the world economy.