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What is Behind the Huge Drop in Global Trade?

Trade Volumes have Fallen much more Sharply than GDP; Temporary Drop, or Long Term Trend?

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Global trade volumes have shrunk dramatically – and it's not completely clear why.

The world economy starting slowing near the beginning of 2008 and then accelerated last fall with the financial crisis. But the contraction in the economies of most developed economies has been in the low single digits, at the worst.

Yet, global trade volumes have collapsed at a much more significant pace – the exact opposite of the trend the world has seen for many years, in which trade volumes have risen two to three times faster than world GDP growth each year.

For example, estimates are that global trade fell an astounding 31% in January versus the previous year. China, Japan and South Korea are among the many nations that have individually reported similarly steep decreases in export volumes.

"The recent sharp contraction of trade appears to be far more severe than would be expected given the decline in global economic activity," said Federal Reserve Bank of Atlanta President Dennis Lockhart in a recent speech.

That fall has not only had a huge economic impact on export-dependent nations, but also wreaked havoc on the ocean carriers as well, who have seen shipping rates plummet to below operating costs in some cases, while the industry continues take ships off-line to reduce capacity.

Drops of that magnitude have left some observers scratching their heads as to what exactly is going on, especially as many believe trade is essential to leading the global economy back on to a growth path.

By some estimates, the cost of trade credit has risen more than 500% since the financial crisis hit, making some export deals unaffordable. In response, The World Bank, along with some countries such as Great Britain, have announced programs to subsidize trade finance.

Potential factors behind the trade implosion include:

- **Manufacturing Basis Skews Results:** One simple explanation is that because exports are mostly for manufactured products, it is natural that they would fall more than Western economies as a whole, which have become more services oriented. Manufacturers or retailers can rapidly reduce inventories in the face of slowing demand, resulting in a dramatic swing in imports of parts or finished goods in the short term, even as the services elements of the economy do not fall at nearly the same rate. As a result, imports fall at a much steeper rate than the drop in GDP.

- **Domestic Sourcing Bias:** If a company can source internally or externally from multiple

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sources, and one of those is a domestic source, it is likely that the company would keep as much volume as it can at the domestic source for both economic and psychological reasons. If it is a company-owned factory, there are obvious reasons for trying to maintain as much volume as possible there. Even if it is an outside supplier, the ability to manage lead times and inventories with a domestic source can be especially appealing in volatile times. Some companies may also believe it is the "right thing to do" to protect domestic volume first.

- **Impact of Long Lead Times:** Similarly, Asian sourcing in particular often involves very long lead times, not just for the actual physical logistics processes, which can take several weeks, but the entire purchase order to delivery cycle, which can stretch to several months in many cases. In an uncertain economy, buyers are naturally reluctant to make large commitments today for several months down the road, so they make very conservative buys.
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- **Trade Credit is Very Tight:** A significant portion of global trade is dependent on "trade credit," which finances goods for exporters while in transit. In the past year, availability of that credit has dried up sharply with the contraction in the credit markets overall. That has left some companies, especially smaller ones, unable to get trade credit at all, and raised the costs of that credit much higher even for larger companies that can still get it. By some estimates, the cost of trade credit has risen more than 500% since the financial crisis hit, making some export deals unaffordable. In response, The World Bank, along with some countries such as Great Britain, have announ-ced programs to subsidize trade finance.

Despite some political rhetoric and populist unrest in many countries related to "globalization," to date domestic protectionism does not appear to be any sort of significant factor in the sharp fall in trade volumes.

What many experts fear is that protectionist moves will be made just as the economy is starting to recover, putting more pressure on trade volumes and ultimately global GDP growth.