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How the Effects of the Global Financial Crisis Play Out Via Trade

In order to assess the implications of the current crisis for small countries' trade, it is important to understand in what ways developing countries' trade may be affected by the crisis. An equally important starting point is to examine the characteristics of small states and in what ways these determine the extent to which the global financial crisis displays its effects via the channel of trade. Sections 2 and 3 address these issues and derive the expected trade implications of the crisis on small states.

The major trade-related effects of any financial and economic crisis are demonstrated in countries' exports. In general, exports will be adversely affected by three sets of factors:

- First, lower demand for goods and services due to decreasing income and worsening expectations (which influence demand for capital goods);
- Second, drying up of credit availability (affecting both demand and supply);
- Third, rising protectionism that makes imports relatively more expensive than domestic production.

2.1 Lower demand for imports

Developing countries – and small states in particular – usually depend on the export of a few goods and services for the bulk of their export revenue. The income elasticity of demand for goods and services in the importing country is therefore an essential element in how an economic crisis affects export revenue.[3]

Fuel and mining products are highly responsive to changes in global gross domestic product (GDP). Lower utilisation of production capacities translates directly into reduced demand for these products. Since the production of fuel and mining products is fixed in the short run, the oversupply depresses the price further.

Agriculture products are generally fairly income inelastic, as posited in Engel's Law;[4] the more the good satisfies primary needs, the lower its income elasticity of demand. This applies to food products, and generally also includes products like tea and coffee.

Many traditional agricultural exporters have diversified into non-traditional agricultural exports, such as exotic fruits and fresh vegetables, which are generally perceived to be less affected by volatility in the terms of trade and to reap higher export revenues (AfDB, 2004). Similarly, traditional food items which have been differentiated through marketing or production processes, such as 'fair trade coffee' or 'organic cocoa', are less affected by volatile commodity prices. However, as the income elasticity for these 'luxury' agricultural items is higher than for basic crops, they are likely to be substituted by domestic goods or canned products in times of crisis. The deeper the crisis, the more likely it is that traditional agricultural products will also be affected by decreasing demand. The Asian crisis resulted in reduced demand for coffee, palm oil, rice, sugar, rubber, cocoa and tea (Barichello, 1999).

As with fuel and mining products, developing countries' possible volume response in the case of agricultural products is slow. Because of the nature of production, countries are only able to respond to lower prices at the next harvest, and this risks depressing prices even further through supply overhangs.

Developing countries' manufactured goods, such as clothing or electronics, show an income elasticity of demand greater than 1; i.e. a decline in income in the export market will lead to a more than proportionate decline in demand for manufactured goods. Several south-east Asian countries depend on the export of simple manufactures for the bulk of their export revenue. As discussed by UNCTAD (2002), the concentration on an outward-oriented industrialisation strategy based on simple manufactured exports carries a risk of fluctuating and deteriorating terms of trade similar to that involved in the export of primary products, because developing countries with large supply capacities are able to produce labour-intensive high-quality products at lower cost than are small developing countries. Consequently, global competition for simple manufactured goods is very high, exerting a downward influence on prices and terms of trade. An economic crisis affects developing country manufactured exports not only because of the high income elasticity of demand for manufactured products, but also because of their high dependency on imported inputs. The sourcing of inputs for manufactured exports might be severely constrained by depreciated currencies and restrictive trade finance conditions, as experienced by south-east Asian exporters of computer and electronic equipment during the 1997 crisis (Ernst, 1999).

Income elasticities of developing country exports depend not only on the composition of their exports, but also on their destination. Virtually all fuel and mining exports go to unspecified world markets and are heavily dependent on changes in world GDP. For agricultural exports, however, the situation is more complex. Least developed countries (LDCs) and the African, Caribbean and Pacific (ACP) group enjoy duty- and quota-free access to the European Union (EU), where the agricultural market is regulated by the Common Agricultural Policy. Most EU agricultural products have price levels that are considerably above those on the world market and are stabilised by interventionist policies, which makes the EU an attractive export destination for LDC and ACP agro-exports. Preferential market access (albeit less good than for LDCs and ACP countries) is also granted to a range of countries from Latin America and eastern Europe under the special incentive arrangement for sustainable development and good governance in the EU's Generalised System of Preferences (GSP+), as well as to developing countries with which the EU has entered into free trade agreements (e.g. South Africa, Chile, Mexico, and some North African and Middle East countries).

UNCTAD (2009) estimated that world merchandise trade would fall by 6–8 per cent in 2009. It was estimated that in the same year exports from developing countries and countries with economies in transition could potentially decline by 7–9 per cent in volume.

Services exports are usually income elastic, particularly in the case of tourism, which is the major export of several developing countries. However, according to US import data, trade in services appears to be more resilient than merchandise trade in the current crisis, i.e. services imports have fallen by less than merchandise imports (Borchert and Mattoo, 2009). While imports of tourism and transport services (which are linked to trade in goods) have dropped by a proportion similar to merchandise imports, other services imports, and in particular business services, saw little change in the first quarter of 2009. This is probably due to a number of factors, including the cost effectiveness of outsourcing these types of service (e.g. information technology enabled services) in times of crisis and the relative independence of these types of services from trade finance, which is more of a constraint for trade in goods.

2.2 Worsening access to credit

The second obstacle to trade is the increasing shortage of credit. This operates directly, through drying up of trade finance (which effectively reduces import demand), and indirectly, through difficult access to credit for producers of exportables, who thus need to reduce the supply of exports.

As already mentioned, the trade finance problem is especially worrying for manufacturing industries, while it is less serious for services. The extent to which companies are exposed to the problem of availability and cost of credit for export finance will depend on the nature of the value chains within which they operate (Meyn and Kennan, 2009). Trade finance, for instance, has been cut back in several countries, such as Argentina, Brazil, Thailand and Hong Kong (TPU, 2009). The same situation has not yet been reported in Bangladesh and Indonesia, possibly because of the greater influence of their governments on the banking system (te Velde *et al.*, 2009a).

The trade finance problem appears to reflect a more general problem of credit availability, which constrains the supply of products of a large number of firms, especially in developing countries. The collapse of credit associated with the recession has hit particularly hard those industries requiring large amounts of credit, such as the capital goods and vehicle sectors. Francois and Woerz (2009) calculate that almost two-thirds of the real drop in US exports is explained by motor vehicles and capital goods alone. The fall in exports is consistent with the decline in production of the industry as a whole. Between February 2008 and February 2009, US production of cars dropped by 60 per cent, while real exports fell by 'only' 45 per cent.

This problem is compounded in developing countries by the possible diversion of funds to developed countries, which are in increasing need of finance and represent a safer destination for investors than developing markets in times of crisis (flight to quality). Moreover, the subtle pressure of developed country governments on their banks to lend in the domestic market may further divert finance away from developing countries.

2.3 Incipient and murky protectionism

The final potential cause of trade decline is protectionism. There have been only a few signs of outright protectionism (Chauffour and Malouche, 2009), mainly in developing and transition countries (e.g. Ecuador, Colombia and Russia). This pattern may signal the effectiveness of the multilateral system of trade rules. However, governments, especially in high-income countries, have implemented trade-distorting stimulus packages targeted at troubled export industries or competing import industries. Such subsidies have little direct impact on small states' exports as they operate mainly in capital-intensive manufacturing and services industries (e.g. airlines, construction, steel, semi-conductors and automobiles), where small states' exports tend not to compete. A number of countries have passed non-tariff measures, such as Argentina's imposition of non-automatic licensing requirements on a number of manufactured goods and Indonesia's requirement that imports of five categories of goods be permitted through only five ports and airports (Newfarmer and Gamberoni, 2009). Incipient signs of protectionist tendencies are also confirmed by an increase in the number of anti-dumping cases in 2008, especially in the second semester after a period of slowdown.

While these forms of protectionism mainly apply to manufactured goods, and thus do not involve most small state exports, other forms (such as those on services) do apply to the exports of small states. These are more subtle forms of protectionism, likely to erode the access of service exporters to industrialised countries' markets. For example, the increasing hostility of governments towards financial offshore centres has put the providers of these services, the majority of which are small states, under considerable pressure. More importantly, the mounting social and political aversion to the immigration of service providers that is emerging in crisis-hit countries is generating increasingly strong implicit political pressure to retain jobs domestically (Borchert and Mattoo, 2009). This may constrain Mode 4 types of exports by developing countries, which are an important source of external revenues for small states.