

On the Brink of Deglobalization

**An Alternative Perspective on the
Causes of the World Trade Collapse**

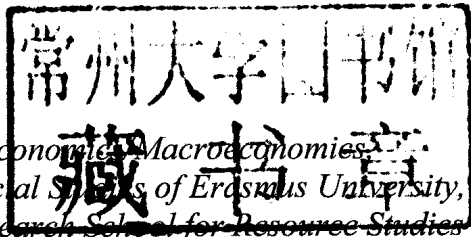
Peter A.G. van Bergeijk

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World Trade Collapse

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Preface and Acknowledgements

In February 2009 I started in a new job as a professor of international economics and macroeconomics. It could not have been a more timely appointment for me because one of the major intellectual challenges for the subject field of international economics was well underway. Not many people were actually worrying about the risky developments of world trade at that moment, although some already speculated on this topic of course. So did I when I was commenting on the launch of the OECD's *Development Co-operation Report 2009* on February 18, 2009 at the premises of the Institute of Social Studies in The Hague: 'We do not have the data yet, but we can try to glean beyond the report at what is happening and what this means. It is to be expected that low income earners will be hit hardest and especially in countries where no social security safety nets exist. Developing countries that opened up to the world economy are now experiencing the down side of strategies that – for good reasons – relied on international trade and foreign direct investment to achieve national development. Presently international trade volumes are collapsing and foreign direct investment decisions are probably being postponed if not cancelled as a consequence of the credit crisis. Also other sources of foreign finance will dry up: remittances from expatriates, bank lending, and portfolio investment will in all likelihood not provide a leeway.'

Early April 2009 I started the research project on the world trade collapse on which this book is based. At that time one could still only hypothesize that trade would become a casualty of the financial crisis because the available data sources – with the exceptions of the *CPB World Trade Monitor* (that had been launched on March 20, 2009) and the so-called 'Baltic dry index' (that tracks worldwide international shipping prices) – did not yet provide indications of the very strong trade collapse that we know now was taking place at that moment. I started the project in order to have something interesting to tell in my inaugural lecture 'I come to bury globalization, not to praise it' for which I had set the date at October 29, 2009, eighty years after the Wall Street Crash. With hindsight it was a perfect date: it also appeared to be the first anniversary of the start of the world trade collapse

This book is a low pretence exercise that only aims to make a scientific but still very preliminary assessment of recent contributions to the literature. It

attempts to distil some of the empirical regularities that are emerging in data that will be updated and revised over the next quarters if not months. Perhaps someone would want to object that it is much more scientific to wait longer and then make a better, more precise and perhaps less uncertain analysis. I also do not develop a formal model but work with descriptive statistics and simple quasi-postulated reduced form equations that in a very common sense approach take account of some of the explanations for the world trade collapse that have been floated in the literature. Also this lack of formal structure may attract criticism from academia. For a preliminary assessment, however, the methodology suffices. Such a preliminary assessment in my opinion is much needed: the problems posed by the world trade collapse are too serious to take the intellectual luxury to wait for the perfect analysis.

ACKNOWLEDGEMENTS

The first research output of the project was published in Dutch on May 1, 2009 in *Economisch Statistische Berichten* (an English version of that article appears in the November 2009 issue of *Kyklos*) and these articles – updated and amended – form the basis for Chapter 2. I benefitted from the comments by the editors and referees. I was also helped because I could present the ideas in this book in raw shape at a number of workshops and seminars. I would like to thank the organizers and discussants at these meetings, in particular ECORYS in Rotterdam (April 16, 2009), Groningen University (September 14, 2009), the HIVOS strategy meeting in Noordwijk (September 17, 2009), ISS's Research in Progress (October 1, 2009), CPB Netherlands Bureau for Economic Analysis (October 13, 2009) and VNO-NCW (November 12, 2009). Steven Brakman and Karel Jansen were very critical and helpful in commenting on a first draft of the manuscript. I would also like to thank my students, especially those attending courses 4207 and 4312 at ISS and the students of BOFEB where I had a try-out of ideas for a very critical public.

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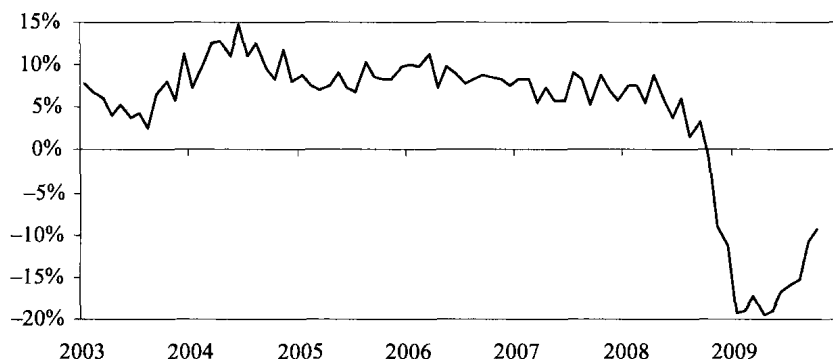
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1. Introduction: Setting the Stage

October 2008 had something extraordinary in store for globalization. In the years 2004–2008 the world trade volume had been growing at an annual rate of between 5 and 10 per cent. These were high numbers but they were not outside the usual range for the development of real exports and imports at the global level – world trade over the period 1950–2008 grew by about 6 per cent per annum leading to a 25-fold increase in the volume of merchandise trade. In October 2008 world trade, however, suddenly came to a virtual halt and then started to decline. This decline rapidly turned into a collapse. In November 2008 the global trade volume declined by 7 per cent. December 2008 added 3 per cent; January 2009 another 7 per cent: early 2009 trade figures were about 20 per cent lower in real terms than they had been just one year earlier (Figure 1.1).



Source: CPB world trade monitor at www.cpb.nl

Figure 1.1 Growth rate of world trade with respect to same month in the previous year (2003–2009)

In the second half of 2009 some recovery occurred. According to the December 2009 issue of the CPB *World Trade Monitor*: ‘In October, world trade was still 13.2% below the peak level reached in April 2008 mainly resulting from the unprecedented drops in November 2008 up to January

2009. Compared to [2008] world trade was down by 9.4% in October, but it was already 9.0% above the trough reached in May 2009’.

This book deals with the collapse of trade and not so much with its recovery. It is not a study on the full ‘business cycle’ of trade as it focuses on the downturn (and its potential continuation) and the lessons that this exceptional ‘natural experiment’ provide for economic scientists and policy makers. The main narrative for this phenomenon is that the world trade collapse was caused by the collapses of (i) trade credit, (ii) international value chains and (iii) the multilateral policy approach to free trade (an increase in protectionism). This book will clarify that this theory for the world trade collapse collapses when confronted with the data. Focussing on the development of import volumes, I suggest an alternative explanation, namely that the trade collapse was driven by a shock of (perceived) trade uncertainty and provide some preliminary evidence for this hypothesis.

Typically, the mainstream analysis is based on preconceptions about what the drivers of the trade collapse should be. This book challenges the mainstream narrative of the world trade collapse because that narrative is wrong and because it provides the wrong kind of policy advice, thus increasing the risk of a deepening and prolongation of the crisis in international trade. Even when the mainstream explanations are refuted by data analysis, authors often stick to the idea that theory must somewhere be right and that the data must somewhere be wrong. The latter may be right but the former is a *non sequitur* or at least a very *non-empirical* argument. The fact that data are imperfect most of the time, only available with substantial delay and often do not exist, however, to a large extent could explain why many wrong ideas are able to survive for so long. The bottom line is that the economic profession does not offer a convincing explanation yet.

Admittedly, the profession, in particular the economists at the international institutions, has provided a long list of potential explanations, but we are far away from a real understanding of the 2008–2009 trade collapse.¹ This will become evident when we scrutinize in later chapters the explanations on the long list that the World Trade Organization put forward in its *World Trade Report 2009* (WTO 2009b, p. 2 and p. 18). The WTO suggests six explanations for the strength of the trade collapse: the decrease of commodity prices, swings in the value of the US dollar, the concurrence of problems in all countries, the occurrence and intensity of global supply chains, shortage of trade finance, and an increase in protectionism. The other organizations have echoed the WTO’s long list which appears to have had a strong intuitive appeal, often stressing some of the factors that in particular relate to their respective missions.

The WTO’s analysis is especially noteworthy because it is rather disappointing. This is true for the quantity of the reported analysis (which

covers one half of a page – out of a report with a total of 196 pages – and one footnote). It is also true for the quality of the analysis as many of the listed ‘explanations’ actually are logically flawed and have potentially dangerous policy conclusions as we will see in later chapters.²

Box 1.1 Factors explaining the extent of the world trade collapse according to the WTO’s World Trade Report 2009

One reason is that the fall-off in demand is more widespread than in the past, as all regions of the world economy are slowing at once.

A second reason for the magnitude of recent declines relates to the increasing presence of global supply chains in total trade. Trade contraction or expansion is no longer simply a question of changes in trade flows between a producing country and a consuming country – goods cross many frontiers during the production process and components in the final product are counted every time they cross a frontier. The only way of avoiding this effect, whose magnitude can only be guessed at in the absence of systematic information, would be to measure trade transactions on the basis of the value added at each stage of the production process. Since value added, or the return to factors of production, is the real measure of income in the economy, and trade is a gross flow rather than a measure of income, it follows that strong increases or decreases in trade flow numbers should not be interpreted as an accurate guide to what is actually happening to incomes and employment.

A third element that is likely to contribute to the contraction of trade is a shortage of trade finance. This has clearly been a problem and it is receiving particular attention from international institutions and governments. The WTO has played its part by bringing together the key players to work on ensuring the availability and affordability of trade finance.

A fourth factor that could contribute to trade contraction is an increase in protection measures. Any rises in these measures will threaten the prospects for recovery and prolong the downturn. The risk of growing protectionism is a source of concern.*

- * Two factors that might accentuate the extent of year-on-year declines in monthly data in value terms are the higher commodity prices that prevailed a year ago and increases in the value of the US dollar compared with most other currencies.

Source: WTO (2009c, p. 2 and p. 18)

One relatively easy and obvious point that can be cleared right away is that two ‘WTO explanations’ for the strength and speed of the trade collapse relate to the monetary value of trade flows. Monetary variations are of course relevant for the interpretation of the headline figures on international trade which are often in current prices and US dollars, but these measurement issues do not have an impact on changes in trade volume which is what we will study in this book.³

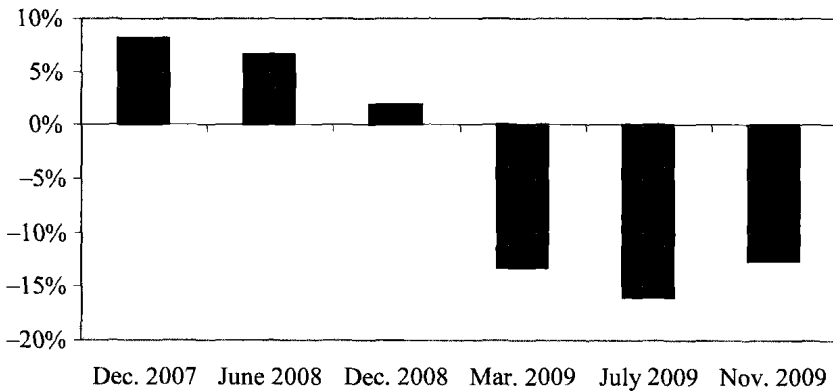
It is true that price movements played an important role in the 1930s due to the occurrence of a process of deflation which worsened the depression, but this was not the case in 2008–2009 (see Figure 1.4 below).⁴ Anyhow, since we will be studying the changes in trade *volumes* we will have to look for other reasons for the world trade collapse.⁵

In any case it is noteworthy that many of the proposed explanations for the 2008–2009 trade collapse have not been put to the test yet, essentially because data are not available (a) for a sufficiently long period or (b) at the level of detail that is necessary to test some of the ‘explanations’ – which actually are still ‘hypotheses’ and should be treated accordingly. This book will discuss and investigate these hypotheses and where appropriate and possible will attempt to provide tests of their validity. As will become clear it is not easy to find the ‘smoking gun’ as indeed other researchers (for example Levchenko et al. 2009) have also pointed out.

A Complete Surprise

It is, moreover, a truism that the trade collapse took the economic profession completely by surprise.⁶ Between December 2007 when the financial crisis started and July 2009, the OECD, for example, revised its prediction for the growth rate of world trade from +8 per cent to –16 per cent, that is an unprecedented 24 percentage points revision (see Figure 1.2).⁷ Importantly, other international organizations such as the World Bank, the WTO and IMF did no better. During 2009 global trade projections were continuously revised downward. By the beginning of July 2009 they revised their April 2009 projections (World Bank 2009a; WTO 2009a and IMF 2009a) of –6.1 per cent, –9 per cent and –11 per cent, respectively to –9.7 per cent, –10 per cent, and –12.2 per cent, respectively (World Bank 2009b, WTO 2009b and IMF 2009b). A protracted recession scenario drawn up by the World Bank in the summer of 2009 (World Bank 2009b, p. 33) included shrinkage of –11.9 per cent in 2009 and, additionally, –4.7 per cent in 2010.⁸

Indeed, it is unfortunate but true that this crisis shows again that the economic profession is a lot better in explaining *post mortem* why the patient died than in predicting the advent of the deglobalization virus (or its defeat, for that matter).



Sources: OECD (2007, 2008a,b and 2009a,b,c)

Figure 1.2 How the OECD changed its predictions for world trade in the year 2009

Neglecting the Black Swan

A key question for empirical researchers is of course whether anything can be said at all. It may be the case that structural change presently is so far-reaching that econometric analysis (based as it is on past experiences) cannot be used to analyse and/or predict the impact of key economic events. This is especially true for the significant changes in economic relationships and policies (including the sudden revival of old-fashioned but appropriate Keynesian demand stabilization) as witnessed in 2008 and 2009.

Admittedly, it has been possible in the past to estimate meaningful econometric models that continued to work during significant changes in international regimes (examples are van Bergeijk and Oldersma 1990 regarding the fall of the Iron Curtain and van Bergeijk and Berk 2001 regarding the creation of monetary union in Europe). So econometric analysis *per se* is not inappropriate, even regarding seemingly unique events such as the world trade collapse. The point, however, is that much of the recent work that has been done on post Second World War data simply is inappropriate for the analysis of the present crisis because it does not include the Black Swan of the 1930s (cf. Taleb 2007).⁹ A Black Swan is a large-impact, low-probability event. Due to their infrequent occurrence such events are obviously difficult if not impossible to predict.¹⁰ Often Black Swans are treated by econometricians as outliers or such events are simply ignored. Of course the data for the interbellum appear to be less comprehensive and more

inaccurate, but that is no reason to neglect the 1930s. This is especially the case because we have so few observations on world trade collapses.

Actually, the problem is that many economists often appear to behave in the manner of the proverbial drunk who prefers to look for his lost key under the street light and not in the alley (where it was lost) because it is dark over there. Indeed, when economists embark on the road of a specific methodology they will often restrict their analysis to country groupings and periods for which the required data are available. In practice this means that the available analyses often deal with the experiences of a subset of OECD countries after the Second World War period. Many country studies deal with the US only or use US data as a proxy for global conditions (examples are Cheung and Guichard 2009 and Levchenko et al. 2009). Although these studies may be informative, there is no indication (or logic) that the findings for the US can be generalized to other countries or to the global level. The focus on readily available data is not only a waste of available but imperfect observations that cover longer periods; it also implies that the observation that really matters (that is the trade collapse of the 1930s) is not a part of the analysis.

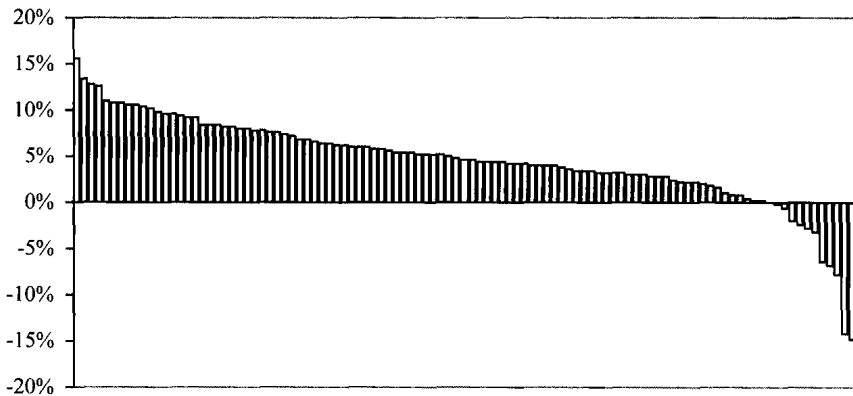
One contribution of this book is that I will not go for the perfect data or method, but that I am prepared to distil sensible evidence from whatever data available, exercising judgement in the interpretation of this evidence. (One exception to this rule should be mentioned right away and that is that China has not been included in the analysis because the data collection and reporting in my opinion are not trustworthy and comparable to other countries.) The methodology is sensible since clearly longer periods and broader country coverage are needed so as to include more cases of the infrequent phenomenon of world trade collapse.

1. A UNIQUE PHENOMENON?

Indeed, declines in the volume of world trade do not occur very often. Defining ‘trade recessions’ as situations in which trade decreases for two months in a row, Faber and van Marrewijk (2009) have analysed the two most recent decades of monthly world trade data.¹¹ Faber and van Marrewijk find only two other world trade recessions: the Asian Crisis (when their indicator decreased from June 1998 to August 1998, inclusive) and the Dotcom Crisis (where the trade recession is dated as January–October 2001). Using a slightly less restrictive definition and focussing on OECD trade rather than on global trade, Araújo and Oliveira Martins (2009) study trade data that cover the period 1965–2007. They find only six periods of negative OECD trade (their worst case is 1982 when OECD trade contracted by about 14 per cent). It is worth pointing out that the level of aggregation matters for the

frequency with which periods of negative real trade growth are being established. Araújo and Oliveira Martins (2009), for example, report that months of negative trade growth below 10 per cent occur in 2.4 per cent of the research period for total OECD trade, but in 4.3 to 6.5 per cent of the research period for the individual country data of France, Germany, Italy, Japan, the UK and the US. Negative trade growth is of course even more unlikely to occur on an annual basis, but when we increase the research period and also include the 1930s, then the phenomenon would seem to be less infrequent that suggested by those analyses that focus on the recent period only.

Using annual trade data for the period 1880–2009, Figure 1.3 illustrates the occurrence of negative annual growth rates for world trade: 12 per cent of the real annual growth rates are negative. Decreases in the volume of *world* trade are thus relatively unique in recent history, but they do occur. It is, however, not only the fact that negative world trade growth occurs with a very low frequency which makes the 2009 world trade collapse an intriguing phenomenon. Also the strength of the decrease is remarkable. The starkest declines in the figure are 1932 and 2009 (note that the 2009 figure is a preliminary estimate).¹² (Chapter 2 takes a more detailed look at the individual country experiences over this period.)

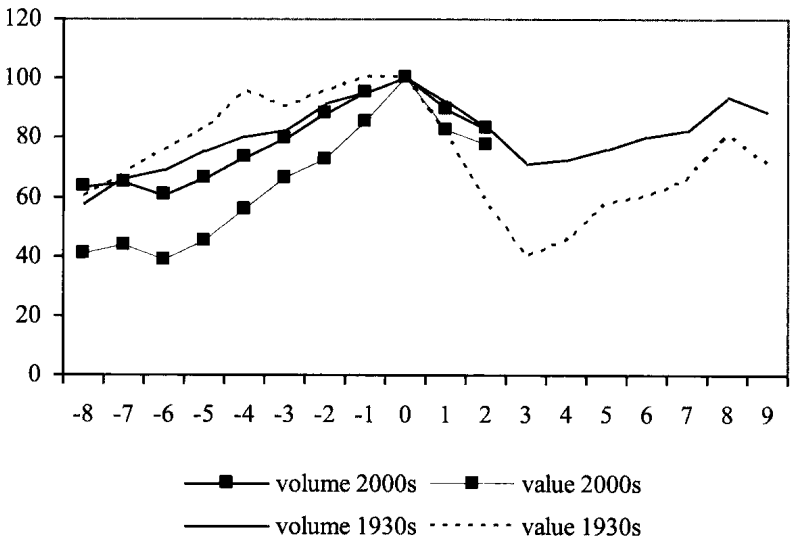


Sources: Calculations based on real trade data for 1880–1991 from Maddison (1995) and for 1992–2009 from *CPB World Trade Monitor*

Figure 1.3 Real annual growth rates in per cent for world trade sorted in decreasing order (1880–2009)

Two World Trade Collapses Compared

A decrease in the volume of world trade of this magnitude has actually not occurred in the post Second World War era. We have to go back to the Great Depression and its aftermath to see a comparable destruction of world trade. Figure 1.4 by way of illustration compares the time path of the trade collapse in the 1930s to that of the trade crunch that started in October 2008, showing the developments of both values and volumes of world trade. Setting the peak at time 0, we can see how trade values and trade volumes continuously increased in the eight years prior to the outburst of both crises and decreased in the years after the peak (the lines in the graph that describe the recent trade collapse have been identified with square markers). In general the real world trade numbers during the two trade collapses so far follow more or less the same pattern, but as the 2008 trade collapse (possibly) moves into its third year it is still too early to tell whether the world economy will follow a comparable trajectory or whether a quicker rebound will occur. The nominal data show clear differences both in the running up to the crisis and in the development during the trade collapses: in contrast to the 1930s when price movements played an important role, values and volumes during the most recent trade collapse appear to have been moving more or less in tandem.

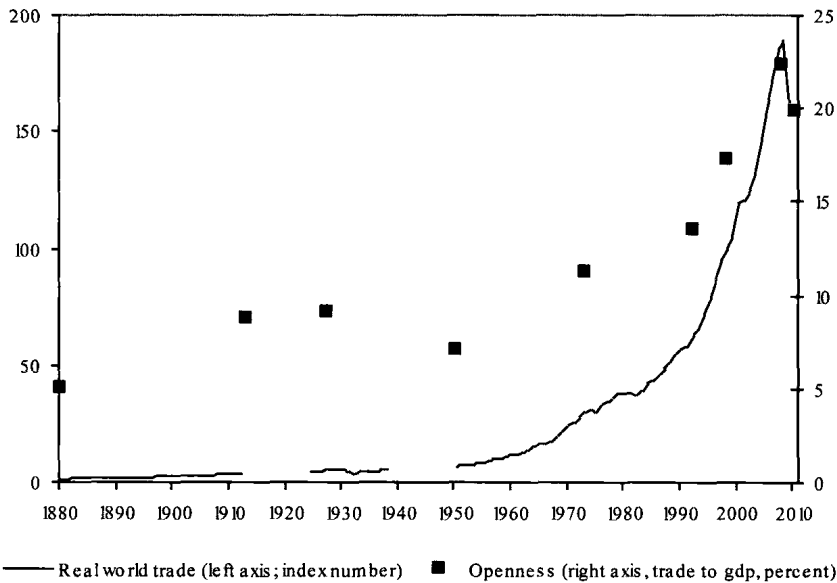


Notes: End of period observations with the exception of 2009. Peak year is 0
Sources: UN Statistical Office (1962), Table I and calculations based on CPB trade monitor

Figure 1.4 Real and nominal world trade before and during the two world trade collapses (index numbers; peak year = 100)

Figure 1.4 thus contradicts the nominal explanations put forward by the WTO in its *World Trade Report 2009* for the strength and speed of the trade collapse. This can be compared to findings by Levchenko et al. (2009, p. 6) who conclude from a detailed sector analysis of US statistics that

it is remarkable that in some important sectors, such as automotive, capital goods, and consumer goods, the prices did not move at all, and the entire decline in nominal exports and imports is accounted for by real quantities.



Sources: Real trade data 1880–1992 and trade to GDP ratios 1880–1998: Maddison (1995) and (2001). Real trade data 1992–2009Q1 *CPB World Trade Monitor*. Trade-to-GDP ratios 2008 and 2010 constructed on the basis of IMF World Economic Outlook Database, April 2009, and have been updated in the basis of IMF (2009b)

Figure 1.5 Historical perspectives on the 2009 trade collapse

It is even possible to put these developments into a longer and more comprehensive historical perspective. Figure 1.5 summarizes data for the development of real world trade since 1880. The line in the graph relates to the left axis and presents index numbers with 1998 as a base year. Since the end of the 19th century world trade had steadily been growing with the exception of the interbellum when a strong break occurred in the long-term trend and the global trade curve shifted downwards. Since the Second World War world trade increased 25-fold and from this perspective the first oil

shock in 1973 and the stagflation of the 1980s show up as mere ripples. So the six decades before 2009 constituted an exceptional chapter in the history of world trade indeed.

Equally exceptional are both the speed and the depth of the downturn of the 2008 trade collapse. Eichengreen and O'Rourke (2009) estimate that the trade collapse in the first year of the 2008–2009 trade collapse was about double the decline that occurred in the similar phase of the Great Depression. Araújo and Oliveira-Martins (2009), moreover, see the exceptionally synchronized character of the downturn as a key characteristic: at the end of 2008 more than 90 per cent of the OECD countries suddenly and simultaneously experienced a decline of their individual trade flows in excess of 10 per cent.

More importantly, it is not only the volume of trade which drifts away from its long-term trend; also openness (that is trade in relation to production) is showing a steep and unique decline (see Estevadeordal et al. 2003 for an historic interpretation of this ratio). The square markers in Figure 1.5 relate to the right axis and summarize a well-known measure of openness, namely the trade-to-GDP ratio (in per cent).¹³ The development of openness again illustrates both the unprecedented impact of the Great Depression and the extraordinarily developments in 2009. Based on recent IMF projections, the world appears to be experiencing its most significant decrease in openness since the 1930s.

Similarities

But are the 1930s a look-alike of the 2000s? Interestingly, many contemporary observations in the interbellum suggest so. Although one could resort to many contemporary observers, I select a clear example of a very rational observer that was intellectually occupied with many of the issues that are central to the present book.¹⁴ Two years ago I discovered in an obscure second-hand bookshop in The Hague a booklet on the business cycle, the economic outlook and the still uncertain impact of what is nowadays known as the Great Depression that was written by the Dutch Noble Price laureate Jan Tinbergen in 1933 (Tinbergen, 1933). Tinbergen's description of his world (incidentally, much like many studies of his contemporaries) shows remarkable similarities with how we ourselves would today describe the globalizing economy at the start of the third millennium (compare Table 1.1).

- Life expectancy increased in the early twentieth century as happened in the greying societies at the end of that epoch.
- Tinbergen noted a strong international reallocation of production towards the periphery ('primitive countries that only recently have become capitalist') in the same manner that many observe today would

describe how the collapse of communism has stimulated the entry of China and other previously centrally planned economies into the world economic system.

- Communication (intercontinental and wireless telegraph) and transport (at the end of the era of sailing and the start of commercial air flight) improved and he studied the important consequences of these innovations: cost reductions and the fact that ‘mental horizons’ shrunk so that new far-away markets were becoming realistic opportunities. In technical economic terms the extent of potential markets increased significantly. Likewise, modern generations witnessed the advent of the container and the Internet, the former being a major transportation cost-reducing innovation, the latter being an equally important cost-reducing factor for the dissemination of knowledge and ideas.
- New products came on the market, such as cars and radios. Likewise the introduction of (portable) computers and mobile phones implied tremendous opportunities both for hardware providers and for producers of content.
- These new industries according to Tinbergen boosted the economy and fuelled the stock exchange booms – not only on their own account but also because they were helped tremendously by financial innovations such as consumer credit and the emergence of investment trust. It goes without saying that financial innovation was also characteristic of the 2000s.
- If anything unrealistic optimism dominated the period before the two trade collapses.

Table 1.1 Some differences and similarities of the context of the 1930s and the 2008 trade collapse

	1930s	2000s
Long-run reductions of trade costs	•	•
New modes of transportation and communication	•	•
Entry of new countries (recent capitalist countries)	•	•
Key innovations	•	•
Financial innovation	•	•
Worldwide crisis	•	•
Trade collapse most pronounced in manufacturing	•	•
Price decreases as an important driver of the trade collapse	•	
Trade mainly based on comparative advantage	•	
Substantial presence of international value chains		•