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COVID-19: Six lessons for international trade

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Summary

This briefing sets out six lessons for international trade in the wake of the COVID-19 crisis:

1. Trade is more volatile than the general economy. Expect a sharper fall in international trade than in Gross Domestic Product (GDP).

2. The COVID-19 slump is a combined supply and demand shock. Expect disruptions for global supply chains and pressure from squeezed trade credit.

3. The big danger of a prolonged slump is the disintegration of trading networks. The longer the COVID-19 disruption lasts, the more likely trading relationships between firms will break down, preventing a swift recovery.

4. Rethinking extreme events and resilience: static vs. dynamic efficiency. Cost minimisation in good times might not be a sustainable model for long-term economic success.

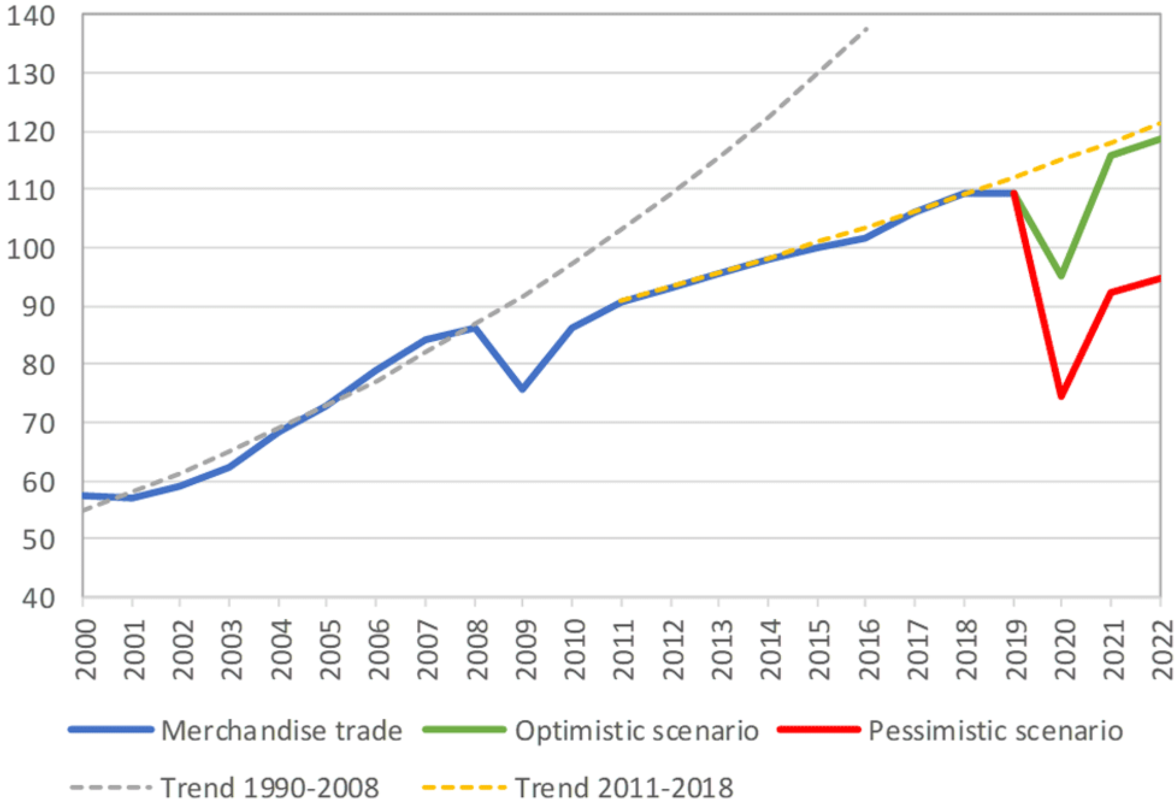
5. Will COVID-19 make firms scale back international value chains? Not necessarily. A more resilient network could mean more international diversification.

6. Will protectionism lead to less international trade? It depends on how successfully elected leaders face up to the challenges of the crisis.

Introduction

International trade is experiencing its biggest slump since at least the Great Depression. The World Trade Organisation (WTO) anticipates an “optimistic scenario” in which global merchandise trade would drop by 13 % in 2020, and a “pessimistic scenario” with a 32 % drop. See Figure 1. These numbers are unprecedented in modern times.

Figure 1: World merchandise trade volume, 2000-2022



Source: WTO press release “Trade set to plunge as COVID-19 pandemic upends global economy”, 08 April 2020.

As we live in a world more dependent on international trade than ever before, we have to heed the lessons from previous trade slumps, in particular the Great Trade Collapse of 2008/09. Given the severity of the COVID-19 shock, policy makers and researchers alike might have to rethink their approach to international trade in fundamental ways.

Below I highlight six crucial aspects. I conclude by discussing policy implications.

1. Trade is more volatile than the general economy. Expect a sharper fall in international trade than GDP.

The composition of international trade is different from the composition of GDP. When the economy enters a slump, consumers cut back most strongly on durable goods and big-ticket items such as cars and furniture. Those are precisely the types of goods that are heavily traded internationally, both as final products and in terms of their intermediate inputs in global supply chains (car parts, raw materials etc.) This composition effect was one of the main reasons why international trade declined much more than GDP in the Great Recession of 2008/09, also dubbed the Great Trade Collapse (Bems, Johnson and Yi, 2013). We should expect the same to happen in the COVID-19 recession eventually.

Moreover, international trade is vulnerable to financial frictions. Trade credit is an essential part of many international transactions, and banks become more hesitant to provide such credit in times of economic distress, not least because they fear difficult enforcement across borders. These financial frictions were another important factor behind the Great Trade Collapse (Amiti and Weinstein, 2011; Chor and Manova, 2012). There is additional evidence of economic uncertainty hitting international trade disproportionately hard (Novy and Taylor, 2020).

In contrast to trade, GDP in advanced economies largely consists of services such as housing, finance, education and healthcare. On average these are more sheltered from the ups and downs of the business cycle. But there are important exceptions in the COVID-19 crisis, notably travel, restaurants and brick-and-mortar retail (Hacioglu, Känzig and Surico, 2020).

2. The COVID-19 slump is a combined supply and demand shock. Expect disruptions for global supply chains and pressure from squeezed trade credit.

The trade slump of 2008/09 was first and foremost the result of a negative demand shock. As the fallout from subprime mortgages and shadow banking spread around the globe, consumers cut back spending, and firms cut back investment. Without doubt we will see similar cutbacks with COVID-19 once average incomes start to fall.

However, in the first instance the arrival of COVID-19 was a supply shock. Those parts of the economy that could not shift to working from home had to halt activity, and rightly so, to stop transmission of the virus. Many factories became idle. Social distancing necessitated the shutdown in particular of travel, tourism and retail. Most governments of advanced economies responded by making wage payments to workers and opening up credit facilities for companies. This was the right response, and we should think of it as disaster relief.

Regarding international trade, the COVID-19 supply shock raises issues of synchronisation within global value chains. If a producer shuts down, this has knock-on effects not only further down but also further up the supply chain. As we learned from the 2011 Japanese earthquake, even locally confined shocks can significantly disrupt production networks (Carvalho, Nirei, Saito and Tahbaz-Salehi, 2016). What's more, different countries imposed lockdowns at different times (China first, Europe and America later). We could therefore see waves of supply chain disruption. The upshot is that firms might struggle to offer their products in the short run even when customers are ready to buy them.

At the same time, it is likely we will see persistent changes in demand, for example stronger demand for personal protective equipment and a further shift towards online services such as e-commerce and video gaming. Even when the COVID-19 crisis has passed, these changes might lead to a reallocation of production factors within and across countries. This adjustment will come with inevitable frictions.

Further trouble is brewing if banks cut back business lending and trade finance, and balance sheets worsen due to rising liabilities and lack of cash flow. Supply chains represent financial networks. This is where policy makers need to think about externalities: by allowing firms to go under, they may weaken the entire network, triggering softer aggregate demand and exacerbating the crisis. The policy response needs to internalise such effects, not just domestically but also internationally. This requires a consideration not solely of the costs but also the benefits of supporting workers and saving businesses.

3. The big danger of a prolonged slump is the disintegration of trading networks. The longer the COVID-19 disruption lasts, the more likely trading relationships between firms will break down, preventing a swift recovery.

Although firms reduced traded quantities with existing foreign partners during the Great Trade Collapse of 2008/09, these relationships for the most part survived. That is, firms rarely gave up relationships altogether. In technical language, trade economists would say that adjustment took place along the intensive margin, not the extensive margin (Behrens, Corcos and Mion, 2013).

Keeping up trading networks after the 2008/09 recession was possible largely because countries experienced a synchronised recession with demand slumping at roughly the same time. This allowed for a swift recovery of international trade once the trough of economic activity was reached.

With COVID-19, however, we face asynchronous supply shocks with different countries imposing lockdowns at different times. In addition, business travel will likely prove impractical for the foreseeable future. These developments might facilitate the breakdown of trading relationships, resulting in a drawn-out trade slump and preventing a fast recovery.

4. Rethinking extreme events and resilience: static vs. dynamic efficiency. Cost minimisation in good times might not be a sustainable model for long-term economic success.

Economists like to think of international trade in terms of comparative advantage and specialisation. If countries focus on what they are relatively good at producing, then all of them can gain (at least in the aggregate). These Ricardian forces have been a key driver of globalisation.

They even hold at the domestic and personal level. During the lockdown, we all had to produce lots of services ourselves that we normally trade with others. Most people probably spent more time than usual on cooking, cleaning and home-schooling and would have happily outsourced some of those activities.

In other words, most economists think of international trade in terms of static efficiency. While the logic of comparative advantage will continue to hold, COVID-19 forces us to think more about tail events. Does short-term cost minimisation guarantee long-term success? What if rare but extreme shocks render just-in-time production uneconomical?

To deal with extreme shocks, perhaps firms would be well advised to invest more in inventory and the diversification of supply chains, re-assessing the trade-off between low costs on the one hand and long-term resilience on the other. Likewise, trade economists might gain from thinking more about dynamic efficiency. We can learn from researchers in other fields such as asset pricing and the economics of climate change. They have long grappled with issues of dynamic efficiency and have developed tools that might turn out useful to trade economists. There are interesting questions to ask: has the market failed in providing resilient production structures? Are firms too short-sighted?

5. Will COVID-19 make firms scale back international value chains? Not necessarily. A more resilient network could mean more international diversification.

International trade can also serve as an insurance mechanism. To the extent that shocks are spatially uncorrelated, trade can help to diversify risk. Firms might therefore think about setting up a more diverse network of alternative suppliers and customers to improve resilience. Those partners could be international or domestic. Some firms could therefore decide to become more international in scope and outlook, not less.

Furthermore, as the COVID-19 experience demonstrates the importance of social distancing in the workplace, firms will likely explore processes that help to keep workers at a distance from each other, both in the office and on the factory floor. This could include further investment in online interaction as many office workers already work from home ('telemigration').

Could the widespread use of online technology such as Zoom facilitate trade in services more generally? The quality of online communications technology has improved so much that workers' services can be separated more and more from their location. A radiologist in Brazil can read X-rays of patients scanned in a British hospital. An accountant in India can work remotely for a real estate company in Canada. The forced experimentation with online working through COVID-19 might make firms see services trade in a new light, but of course that remains to be seen.

6. Will protectionism lead to less international trade? It depends on how successfully elected leaders face up to the challenges of the crisis.

To the surprise of many observers at the time, trade policy restrictions such as import tariffs and anti-dumping duties did not play a major role during the Great Trade Collapse of 2008/09 and did not contribute to the trade slump in a major way (Kee, Neagu and Nicita, 2013). International policy coordination held up reasonably well, and countries by and large refrained from giving in to protectionist instincts and lobbying.

In face of the recent US-China tariff hikes, the global trade policy backdrop looks less favourable today. We cannot yet assess the trade policy response during the COVID-19 crisis, but early indications suggest widespread export bans in some strategic industries, in particular medical supplies such as facemasks and ventilators. (If anything, the trade policy instrument of choice during the Great Trade Collapse was to subsidise exports, not to ban exports.)

Economists tend to be sceptical of trade restrictions because they typically lead to efficiency losses and retaliation by other countries, and better policies such as targeted subsidies might be available. Does this argument apply in the COVID-19 crisis? The answer is generally yes. But there may be some important exceptions. For example, if supply is rationed, does the market deliver a desirable allocation of essential medical products? For developing countries in particular we might have to consider exceptions for humanitarian reasons. For instance, it may be reasonable for a poor country to ban the export of ventilators. Once sold, it is unlikely they will be able to afford replacements as prices jump up and supply might not respond in the short run.

In any event, it seems likely the COVID-19 crisis will be exploited politically by nationalists and populists, arguing that the virus was spread by foreigners and that international trade is inherently flawed, especially if voters struggle to see the advantages to the domestic economy. We do not yet know whether politicians will react by leaning towards more protectionism. A lot will depend on how effectively and competently elected leaders face up to the challenges of the crisis.

Politicians across many countries have already argued for self-sufficiency in the production of essential products such as personal protective equipment, pharmaceuticals and perhaps food. While this might sound intuitive, it is not clear this is a sensible response from an economic point of view. Perhaps building up large-scale inventories would be more efficient than creating purely domestic production structures.

Conclusion: The need for international policy coordination

Historical evidence tells us that trade policies are typically “sticky” and remain in place much longer than the issue they are meant to address. To take a recent example, tariffs between the US and China will be difficult to wind down even if US voters were to usher in a new administration with a mind-set of international collaboration.

In the current crisis policy makers do not only face the challenge of dealing with COVID-19 on a day-to-day basis. They also need to set the stage for a healthy recovery. If governments put in place trade restrictions including misguided industrial policy initiatives and do not let them expire swiftly, then this will hinder a fast return to normal economic conditions. Similarly, if government bailout measures disproportionately favour large or politically connected firms, it might be harder for other firms to weather the crisis and contribute to economic growth afterwards.

We therefore need international cooperation to shape a future global trading system that does not get bogged down by emergency measures inherited from a crisis. If countries are not clear about that long-run strategy, the risk is that we stumble into a new form of protectionism that ultimately few people want. The time to coordinate is now.

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