Boxes

Determinants of the slowdown in global trade: what is the new normal?

Global trade has been exceptionally weak over the past five years. Annual world import growth has been below its long-run average since mid-2011, the longest period of below-trend growth for half a century. Prior to the Great Recession, global trade grew on average roughly twice as fast as global output; since 2012 trade has barely matched the growth rates of world GDP (see Chart A). As a result, the global imports-to-GDP ratio has discontinued its strong upward trend and largely stagnated in the past five years (see Chart B). The observed decline in the gross income elasticity of trade – defined as the average growth rate of world imports divided by the average growth rate of world GDP – raises the question whether the trade weakness represents a temporary deviation from trend or a longer-lasting phenomenon reflecting more fundamental structural changes. The question has been a prominent area of recent research and is highly relevant for central banks seeking to understand the role of external demand and international linkages in shaping the outlook for domestic activity, potential output and inflation. A recent report by experts of the European System of Central Banks (ESCB) finds that the weakness in world trade relative to global GDP is likely to persist, being mainly driven by two developments.

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10 IRC Trade Task Force, “Understanding the weakness in global trade: what is the new normal?”, Occasional Paper Series, No 178, ECB, September 2016. In the report, global GDP is aggregated at market exchange rate weights, whereas in this box global GDP is aggregated at purchasing power parity (PPP) weights to align the results more closely with the Eurosystem staff projections of world GDP.
First, compositional effects dampen the global income elasticity of trade. Shifts in the global trade elasticity can reflect both changes in individual country elasticities and the change in the relative weights of each country within the global aggregate. Thus, in addition to fluctuations in elasticities at the national level, changes in the global elasticity also reflect shifts in import shares and relative growth across countries with different trade intensities. In particular, the increasing importance of emerging economies, whose growth is typically less trade-intensive, has implications for the global trade elasticity. The shift in trade and GDP growth from advanced economies towards emerging market economies implies a weaker relationship between trade and economic activity at the global level. This change in the geographical composition can explain about half of the decline in the global elasticity of trade between the periods 1980-2007 and 2012-15 (see Chart C). To a lesser extent, demand composition effects have also contributed to the global trade slowdown. As import-intensive GDP components – such as investment – have weakened relative to other demand components, import growth has also moderated.


Second, several developments have lowered trade elasticities at the country level. Various structural factors that boosted trade growth in the past, including falling transportation costs and the removal of trade barriers, appear to have largely run their course. Another related factor is the moderation in the expansion of global value chains (GVCs). The growing fragmentation of production processes across international borders had significantly supported gross trade, particularly in the 1990s and early 2000s when intermediate components were increasingly shipped multiple times between economies along their production chains. It appears that the sharp rise in GVCs has stalled and possibly even reversed after 2011 (see Chart D). Anecdotal evidence suggests that increasing protectionist measures such as local content requirements induce firms to increasingly source and produce in their export markets, thereby substituting for earlier trade flows. Furthermore, non-linearities in the link between financial sector development and trade openness may also have contributed to the slowdown in global trade growth. Substantial financial deepening in the last three decades in many countries was associated with increasing trade openness. However, as financial sectors have matured, the positive impact of further financial deepening on trade has weakened. Future support from financial factors to global trade growth is therefore likely to be somewhat limited.

13 See also Box 4 in this issue of the Economic Bulletin.
Looking ahead, the structural factors seem unlikely to reverse over the medium term. The gradual shift of activity towards emerging market economies is widely anticipated to persist. Moreover, the structural developments that boosted trade in the past – falling transportation costs, trade liberalisation, expanding GVCs and financial deepening – are not expected to support trade to the same extent over the medium term.

As such, the “new normal” for the trade elasticity over the medium term is likely to be similar to the weak level observed over recent years on average. Specifically, for the world excluding the euro area, the elasticity fell from around 1.8 over the period 1995-2007 (i.e. before the crisis) to 0.9 over the period 2012-15. Part of the weakness in the recent period is due to large adverse shocks to a small number of countries, particularly Russia and Brazil, in 2015. These have pushed global trade growth significantly below the rate of GDP growth (see Chart E). As these shocks unwind, global trade growth is expected to gradually rise to levels consistent with global GDP, bringing the global trade-income elasticity (excluding the euro area) back to the “new normal” of a value around unity.