Box 1

THE RECENT WEAKNESS IN WORLD TRADE

World trade has been rather weak over the past few quarters. In the second quarter of 2011 world merchandise trade contracted by 0.5% quarter on quarter and recorded only subdued growth of 1.0% in the third quarter. The recent weakness in world trade evoked memories of 2008-09, when world trade last contracted. At that time the decline in world trade was not only exceptionally steep, but also significantly exceeded the fall in global output. A number of factors – such as composition and inventory effects, financial constraints and vertical linkages – were found to have amplified the collapse in trade in 2008 and 2009.[1] Against this backdrop, this box investigates whether similar factors were behind the recent weakness in world trade or whether this was broadly in line with the general cooling of global economic activity.

World trade typically rises and falls with the overall level of global economic activity. This co-movement was also evident in the second and third quarters of 2011, when sluggish growth in global industrial production was mirrored by weak trade dynamics (see Chart A).

1 See the article entitled "Recent developments in global and euro area trade", *Monthly Bulletin*, ECB, August 2010.

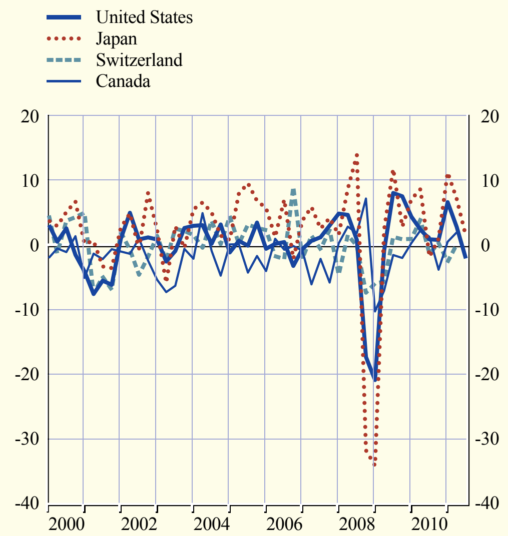
Chart A World trade in goods and world industrial production

(quarter-on-quarter percentage changes)

Source: Netherlands Bureau for Economic Policy Analysis (CPB).
Note: The last observation refers to the third quarter of 2011.

Chart B Import "wedges" for selected major non-euro area OECD countries

(percentage points)



Sources: OECD (Quarterly National Accounts) and ECB staff.
Notes: Positive numbers indicate that actual quarter-on-quarter import growth was stronger than import growth implied by a standard import equation. The last observation refers to the third quarter of 2011 (except Canada and Switzerland, for which the last observation refers to the second quarter of 2011). No timely data are available for the United Kingdom.

However, the question remains as to whether the magnitude of the recent drop in world trade (and the subsequent quarter of subdued growth) was commensurate with global economic conditions. In answering this question, this box adopts the "wedge methodology".[2] Based on country-level data for major non-euro area OECD economies up to the third quarter of 2011 the wedge is derived between a country's actual import growth and the import growth rate "predicted by theory". The latter is based on a calibrated import demand relationship, which assumes that imports will increase with: (i) domestic absorption ("demand"); and (ii) the price of domestic products relative to import prices. A wedge close to zero suggests that trade growth is well explained by absorption and relative prices.

As it turns out, the wedges are relatively small (in absolute value) for the last two quarters in the sample (see Chart B). In other words, import growth was broadly in line with the developments in absorption and relative prices, with little evidence that special factors were dragging down world trade. Similar findings emerge for other OECD economies. In 2008-09, by contrast, exceptionally large negative wedges were recorded in countries such as the United States and Japan, confirming that the drop in imports at the time was significantly steeper than a simple import demand equation would have predicted. These findings are broadly confirmed by more elaborate empirical trade models.

Short-term indicators suggest that world trade is likely to follow global production quite closely in the near term. Following a number of rather weak readings, the Purchasing Managers' Indices

2 For methodological details, see Levchenko, A., Lewis, L. and Tesar, L., "The collapse of international trade during the 2008-2009 crisis: in search of the smoking gun", *Economic Review*, IMF, Vol. 58, No 2, 2010.

(PMIs) tracking global output and new export orders in the manufacturing sector both showed signs of stabilisation in the final quarter of 2011. Notwithstanding this, the global PMI of new export orders remained slightly below the theoretical expansion/contraction threshold of 50, consistent with weak trade dynamics around the turn of the year.

To conclude, the recent weakness in world trade has been broadly in line with weak global economic conditions, with little evidence of special factors dragging it down. Leading indicators suggest that world trade and production are likely to continue to co-move quite closely in the near term.