ECONOMIC CONSULTING SERVICES, LLC

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The Impact of the Financial Crisis on International Trade

Presentation by

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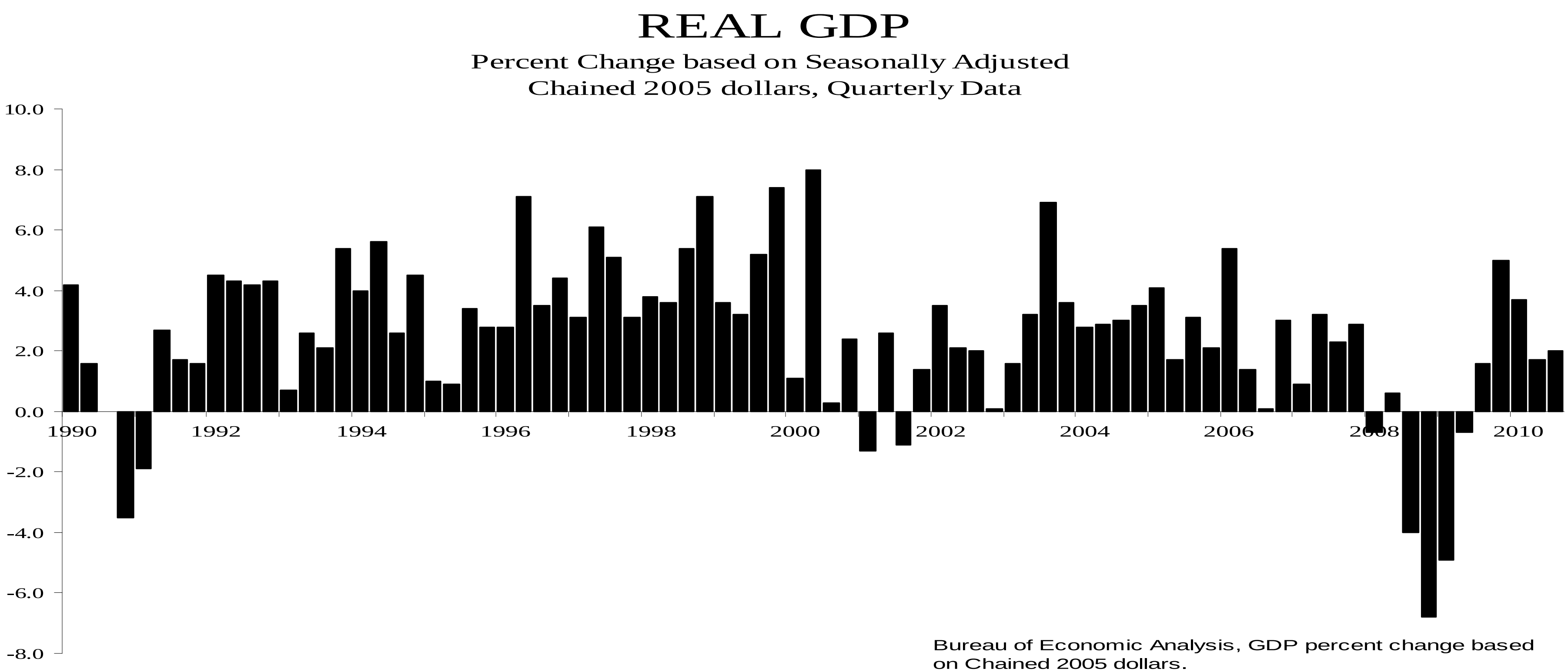
I. The Financial Crisis: What Happened?

It is all about “risk”:

- The price of risk,
- The ability to measure it accurately, and
- Who should bear its cost

Financial Crisis Background

- Two decades of economic growth and relative stability
- Laissez-faire regulation and lack of transparency in the financial system



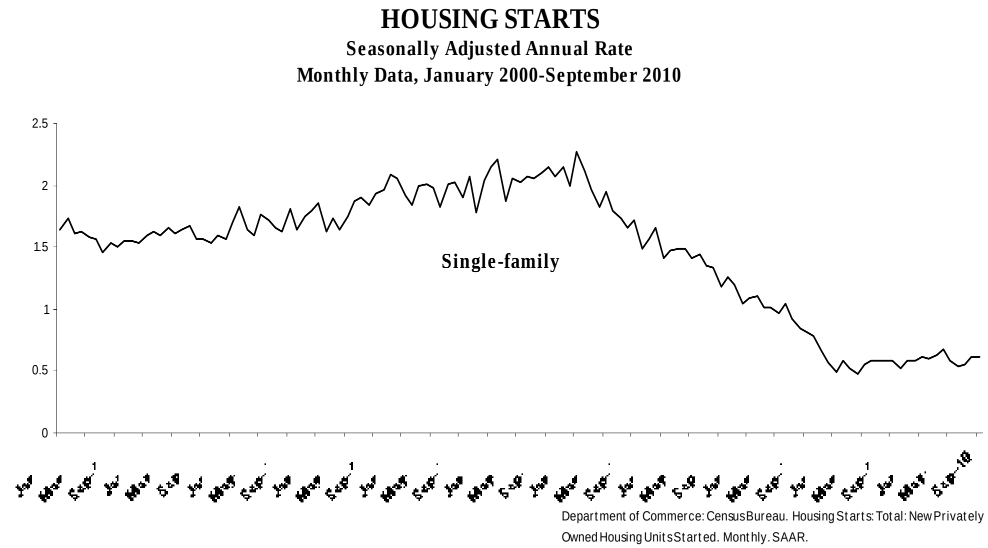
Financial Crisis Background

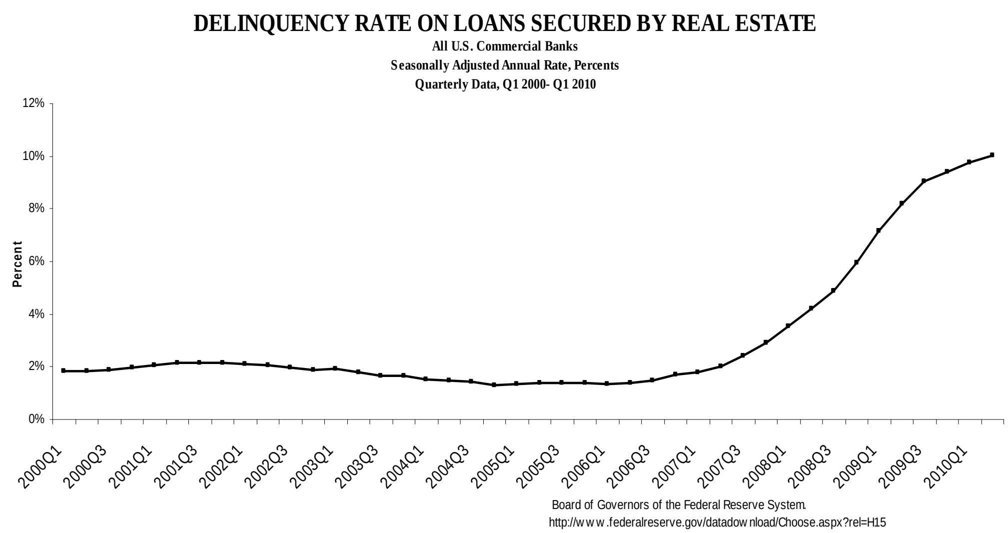
- A housing boom/bubble in 2000-2005 fueled by ample, low-cost credit, including sub-prime mortgage lending

- Commodity price increases led to a reversal of easy monetary policy. The increase in interest rates was exacerbated by Lehman Brothers' failure, which greatly added to the risk premium on debt.

- Housing market peaked in 2006-Q2, followed by an utter collapse and mortgage defaults accelerated at unprecedented rate

- By mid-2007, rising mortgage defaults undermined investments (mortgage-backed instruments) held by major financial institutions





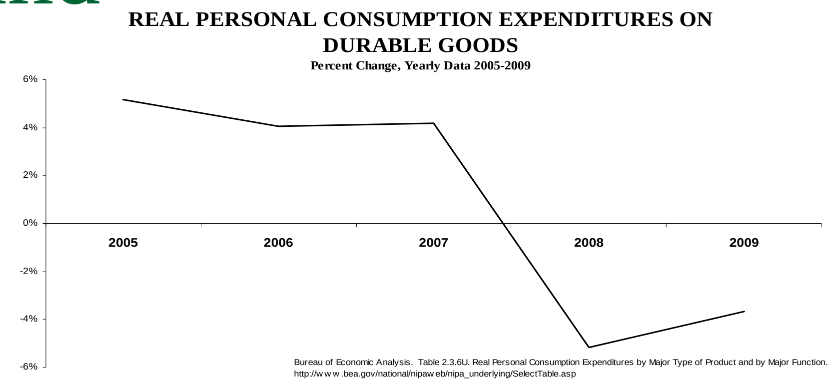
Financial Crisis Background

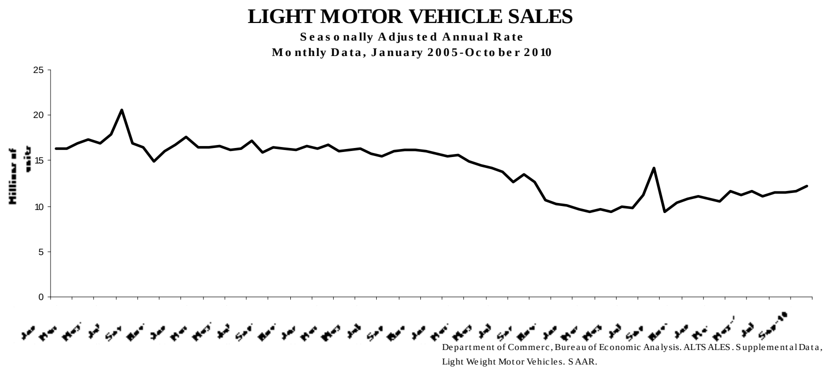
- Summer 2007, crisis brewing:
  - Failure of major financial institutions followed:
  - Countrywide Financial (Jan.’08), Bear Stearns (Mar.’08), IndyMac (Jul.’08), Merrill Lynch (Sep.’08), & Lehman Brothers (Sep.’08)
  - Fannie Mae & Freddie Mac taken over by U.S. Government (Sep.’08)

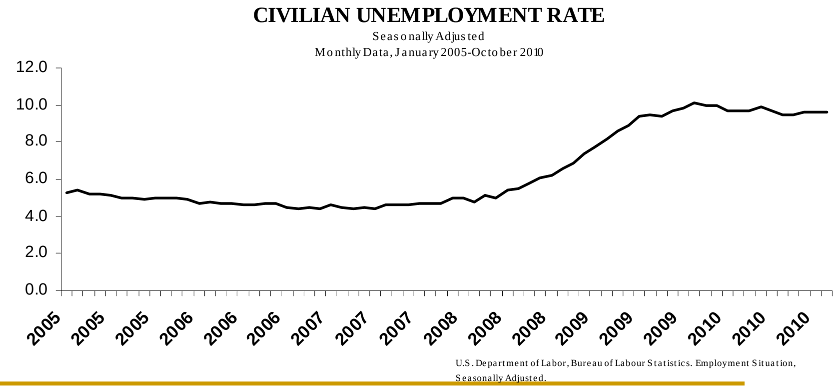
- The “financial” crisis spread to the real economy because of the impacts of reduced credit availability and the decline in personal wealth, causing a decline in consumer spending on durables such as automobiles.

- Unemployment increased and exceeded 10 percent in October of 2009.

- By September 2008, U.S. financial system perceived at risk of collapse. Government viewed as lacking the ability/tools to manage the crisis







II. Global Trade on the Eve of the Financial Crisis

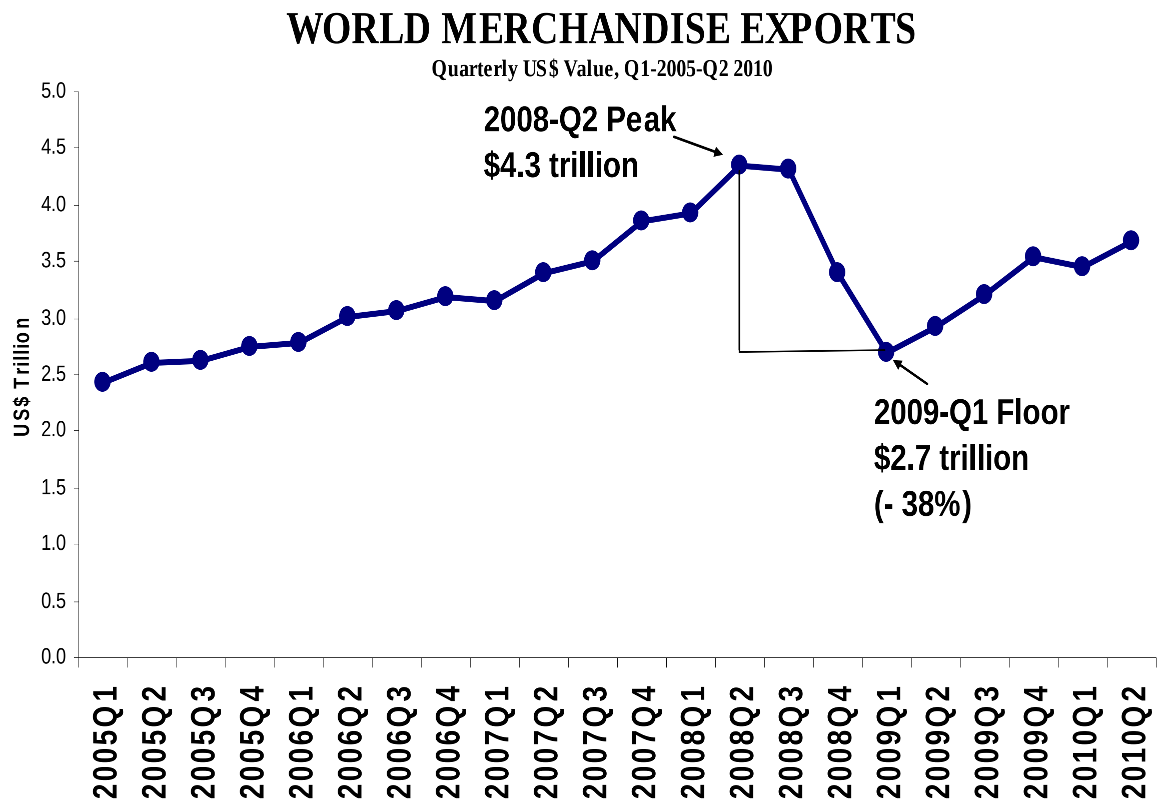
- Global trade rising rapidly in tandem with GDP
  - Global exports peak in 2008-Q2

WTO: Total Merchandise Trade Statistics, Time Series.
http://stat.wto.org/StatisticalProgram/WSDBViewData.aspx?Language=E

WTO: Short-term merchandise trade statistics. Quarterly world merchandise exports by region and selected economies. http://www.wto.org/english/res_e/statis_e/quarterly_world_exp_e.htm

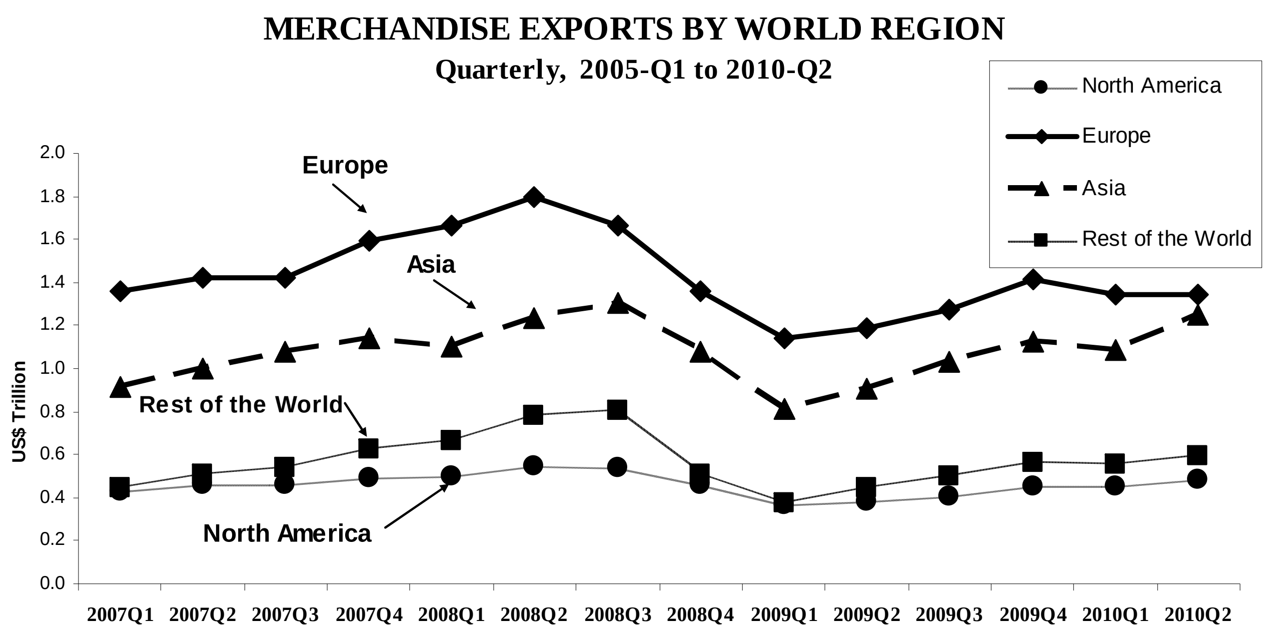
III. The Unprecedented and Dramatic Decline in Global Trade

- Global Merchandise Trade Collapses
- Trade slows in 2008-Q3, and then contracts dramatically. Biggest contraction in trade flows since Great Depression of 1930s
- Nominal annual value of global merchandise trade dropped from $16.1 trillion in 2008 to $12.1 trillion in 2009 (-23%)
- On a quarterly basis, the decline was more severe, from $4.3 trillion in Q2-2008 to $2.7 trillion in Q1-2009 (-38%)



WTO: Short-term merchandise trade statistics. Quarterly world merchandise exports by region and selected economies. http://www.wto.org/english/res_e/statis_e/quarterly_world_exp_e.htm

Synchronized Global Trade Decline Affected All Regions



WTO: Short-term merchandise trade statistics. Quarterly w orld merchandise exports by region and selected economies. http://w w w .w to.org/english/res_e/statis_e/quarterly_w orld_exp_e.htm

Both Trade and GDP Fell

- Merchandise exports fell by -12.2% from 2008 to 2009, while GDP dropped by -2.2%.

	2007	2008	2009	2010 Projected
Volume of Merchandise Exports, % Change				
World	6.5	2.2	**-12.2**	13.5
Developed Economies	4.8	0.8	-15.3	11.5
Developing Economies & CIS	9.0	3.8	-7.8	16.5
Real GDP, % Change				
World	3.8	1.6	**-2.2**	3.0
Developed Economies	2.6	0.4	-3.5	2.1
Developing Economies & CIS	8.0	5.7	2.0	5.9

Source: WTO Secretariat

Decline in Commodity Prices

- Measured on volume basis, the trade decline was less because value measures are affected by the major fall in per-unit prices of oil and other commodities

Indices of Market Prices, 2005=100

	2006	2007	2008	2009
All Primary Commodities	120.8	135.1	**172.3**	**119.0**
Energy	119.4	131.9	**184.7**	**116.8**
Aluminum (US $/MT)				
All Origins (London)	135.4	138.9	**135.6**	**87.8**
Copper (US $/MT)				
United Kingdom (London)	183.1	194.0	**189.4**	**140.5**
Iron Ore (US cents/DMTU)				
Brazil (North Sea Ports)	119.0	130.3	**216.3**	**155.4**
Petroleum, spot (US$/barrel)				
Average crude price	120.5	133.3	**181.9**	**115.8**
Agricultural Raw Materials	108.8	114.2	**113.3**	**94.1**
Wheat (US $/MT)				
United States (US Gulf Pts)	125.8	167.4	**213.8**	**146.6**

Source: IMF, International Financial Statistics, Table: Commodity Prices.

Decline in Commodity Prices Hit Developing Country Export Values Especially Hard

Export Unit Values

(Indices of Unit Values in Terms of US Dollars: 2005=100)

	2008	**2009**
Advanced Economies	121.57	110.50
Emerging & Dev. Economies	151.39	119.79
World	**125.30**	**111.80**
Export Earnings: Fuel	194.48	117.54
Export Earnings: Nonfuel	138.97	121.25

Source: IMF, International Financial Statistics, Table: Export Unit Values/Export Prices

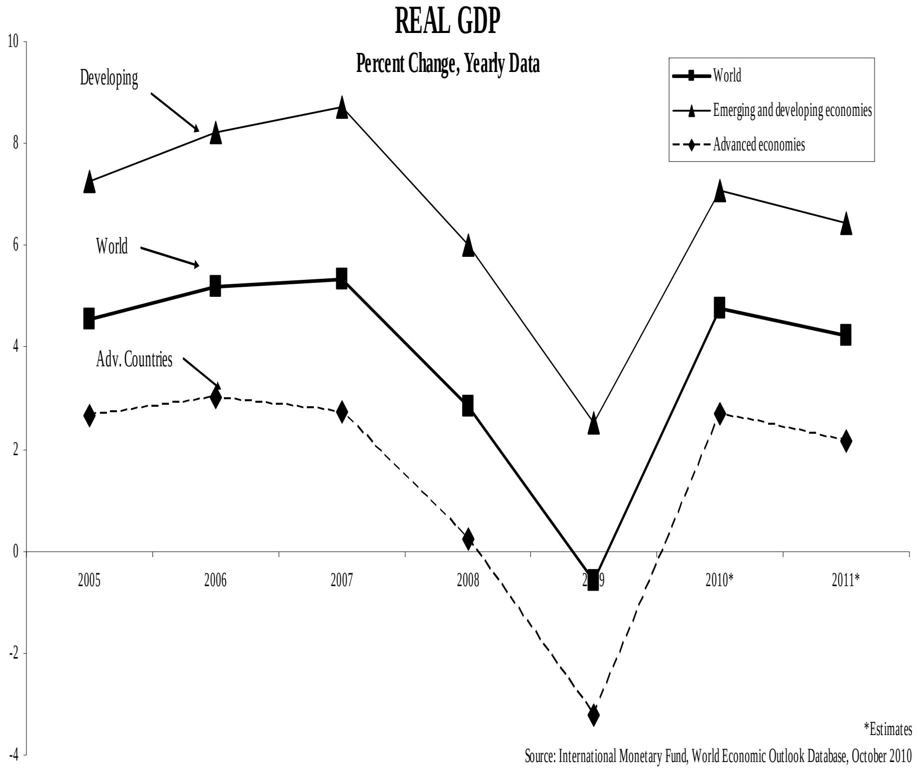
IV. Why Was the Trade Decline So Severe?

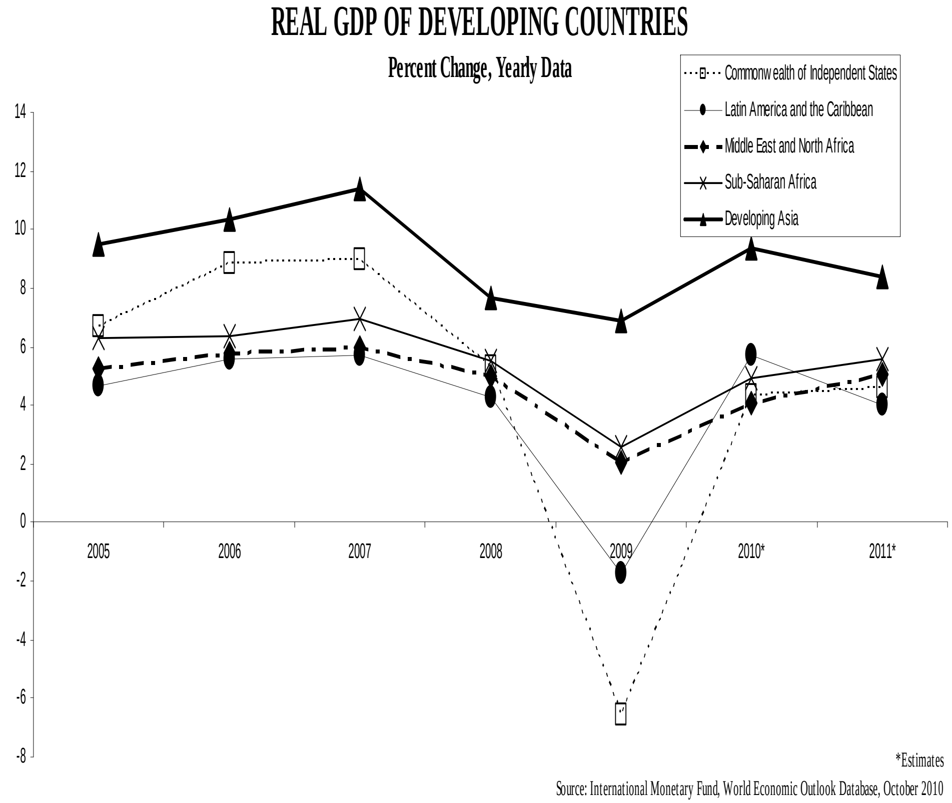
- Global trade dropped five times more rapidly than global GDP.[1]
  - Demand Collapse
  - Change in the Structure of International Trade: The Global Supply Chain
  - Trade Finance Dries Up

[1]Hubert Escaith, Nannette Lindenberg, and Sebastien Miroudot, "International Supply Chains and Trade Elasticity in Times of Global Crisis," WTO Economic Research and Statistics Division, Staff Working Paper ERSD-2010-08, February 2010, p.1.

V. Demand Collapse

- World Bank estimates that 85-90% of the fall in world trade was due to falling international demand.
- Synchronized fall in demand in all world regions





Why Was the Trade Decline Even Greater than the Demand Collapse?

- Proportional decline in trade flows has been much deeper than decline in output.

- A larger fall in domestic demand for highly traded goods (such as machinery and transport equipment) compared to the fall in demand for less-traded goods

- Trade concentrated in durable goods (2/3 or more) vs. GDP, which is mainly services

- <u>GDP</u> is measured as value-added (sum of <u>only</u> the incremental value added by each production step),

  but

  <u>Trade</u> is measured in gross value (sum of the <u>total</u> values of each component and the final good each time they cross any border)

- Expansion of multi-country “supply chains” in international trade

VI. Global Supply Chain Restructures International Trade

- Trade declined not just because of the magnitude of the demand decline, but also because of changes in the "<u>structure</u>" of global demand.

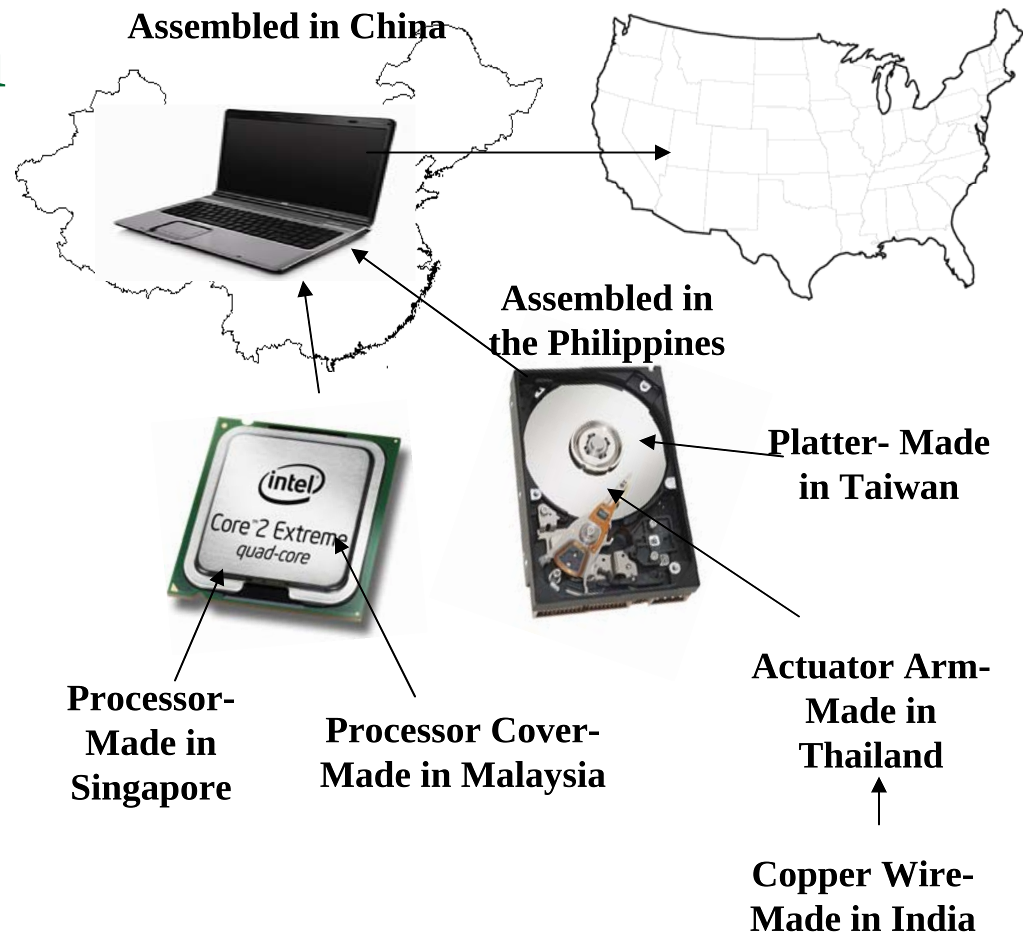
- Old "Ricardian" Single-Country Export Model is being replaced

  By

  the New Global Supply Chain Model

Global Supply Chain

- Growth in vertical fragmentation/specialization in global sourcing.[2]
- Countries become "Nodes" in the supply chain
- U.S. importation of a "Chinese" computer results in imports into China of parts and subcomponents from many other countries: The Value Added Multiplier



- Complexity and synchronization of trade flows increases risks

[2]Kei-Mu Yi, Philadelphia Reserve Bank, *The Collapse of Global Trade: The Role of Vertical Specialization*, Richard Baldwin and Simon Evenett, eds., *The Collapse of Global Trade, Murky Protectionism, and the Crisis: Recommendations for the G20*, Centre for Economic Policy Research (CEPR), London, 2009, p.45

VII. Trade Finance

- World Bank estimates that 10-15% of the drop in global trade is due to fall in supply of trade finance.

- What is trade finance?[3]
    - Loans / credit to permit trade now and payment later
    - Includes trade credit and insurance/guarantees
    - Generally short-term
    - Low-risk, high-collateral end of the credit spectrum (strong receivables and marketable collaterals)

- Trade finance is important
    - Est. 80%-90% of global trade relies on trade finance[4]

[3]Thomas Dorsey, IMF, *Trade Finance Stumbles*, Finance & Development, March 2009.

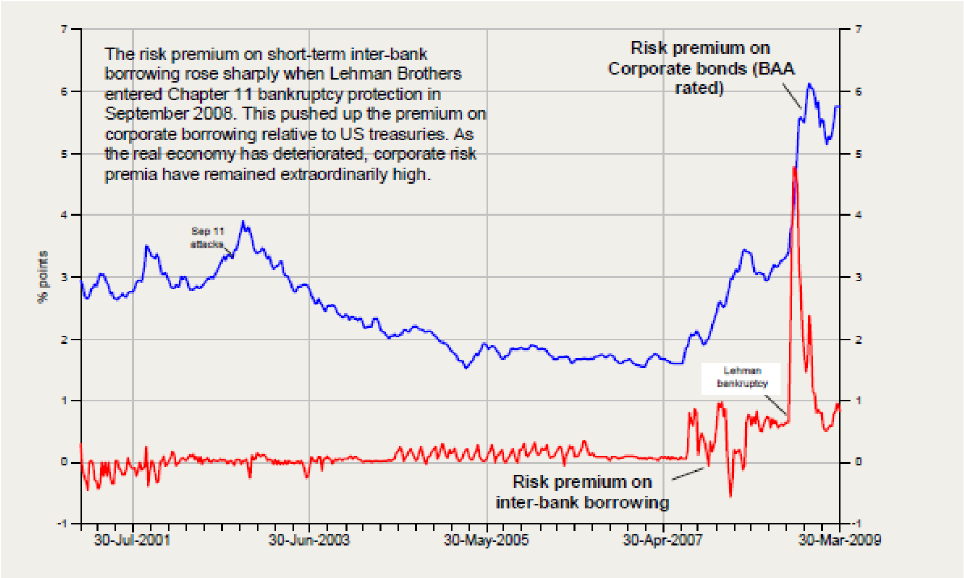
[4] Marc Auboin, WTO Secretariat, *Policy Insight No.35: Boosting the Availability of Trade Finance in the Current Crisis: Background Analysis for a Substantial G20 Package,* Center for Economic Policy Research, June 2009, pg. 1

Trade Financing Declined: Why?

- Cost of Credit Increased
- Availability of Credit Declined

Cost of Credit Increases

- Dramatic increase in interest rate risk spreads
- Normal times, 90-day letter of credit (“LC”) interest rate (“spread”) was 10 to 16 basis points above LIBOR
- Spread soared during 2008 from 250 to 500 basis points for LCs issued by emerging and developing economies.[5]



a Notes: Weekly data. Risk premium on inter-bank borrowing approximated by the rate on one month Euro-dollar deposits less the Federal funds rate. Risk premium on corporate bonds measured as the yield on BAA rated corporate bonds less the 10 year Treasury bond yield.
Data source: Federal Reserve Board.

- Despite the decline in total demand for trade credit, the price of credit (spreads) increased because the available supply fell even more than did demand.

[5] Marc Auboin, WTO Secretartiat, Id., p. 1. See also WTO, *The Challenges of Trade Financing*, www.wto.org/english/thewto_e/coher_e/challenges_e.htm. Downloaded 9/20/2010

Availability of Credit Declined[6]

- Decline in bank liquidity to lend (increased capital requirements; supply constraint)

- Who Can You Trust? The “herd reaction” (element of irrational distrust)
  - Many lenders adopted a cautionary wait-and-see attitude triggered by doubts as to the creditworthiness of banks in a number of regions: Fear of default, called “counter party risk.”
  - Secondary market for credit instruments dried up.
  - Re-insurance market suffered from the difficulties faced by AIG and Lloyds.
  - “Deleveraging” and writing down “bad assets” by financial institutions reduced lendable liquidity.

- Regulator’s Response
  - Federal Reserve and foreign monetary authorities cut interest rates

[6] “Apart from the reduction in the demand for trade, the main reasons provided by banks for the decrease in credit lines and increase in spreads were the application of more stringent credit criteria, capital allocation restrictions, and reduced inter-bank lending.” Marc Auboin, WTO Secretartiat, Id., p.3.

Key Points to Appreciate About Trade Finance

- Complex links and networks of actors involved in the trade finance market.

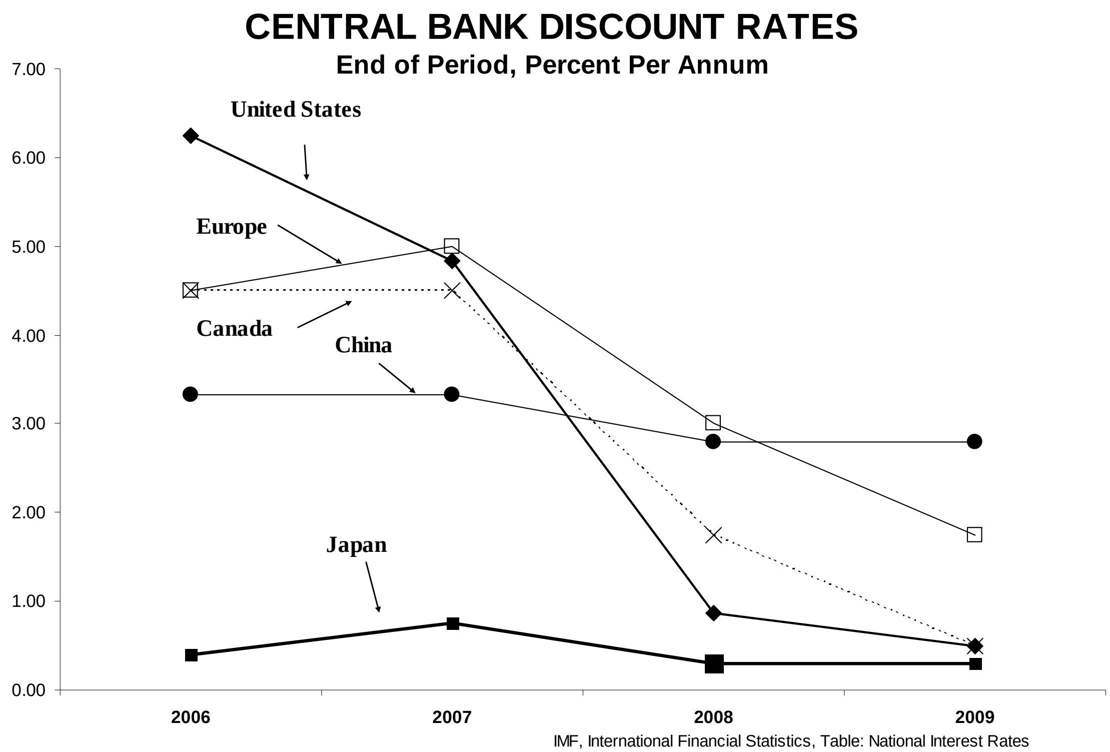
- Vulnerability to the system because of the importance in the global supply chain of
    - Small- and medium-size companies, and
    - Developing country suppliers with relatively weak credit qualifications

VIII. Government Responses to the Financial Crisis

- Monetary Policy
- Fiscal Policy
  - TARP
  - Stimulus Spending
- Trade Policy

Monetary Policy

- Reduced Interest Rates to Encourage Bank Lending



Region	2006	2007	2008	2009
United States	6.25	**4.83**	0.86	**0.50**
Europe	4.50	5.00	3.00	1.75
Canada	4.50	4.50	1.75	0.50
China	3.33	3.33	2.79	2.79
Japan	0.40	0.75	0.30	0.30

Fiscal Policy

- TARP[7], Bailouts, and Stimulus Package; $700 billion authorized, $388 billion spent ($204 billion already repaid)
  - TARP (October 2008)
    - Bank capital programs
    - Automotive companies (2/3 of auto purchases are based on credit)
    - AIG[8]
    - Credit markets
    - Housing programs (also tax credit)
    - Estimates of total ultimate cost of TARP after repayments
      - Treasury $50 billion
      - Congressional Budget Office $66 billion.
- Stimulus spending
    - Cash for auto clunkers (scrappage subsidies in U.S. and elsewhere)

Summary of TARP

Billions $

As of September 30, 2010	Max Allocation	Total Spent	Repaid	Percent Repaid	Income
Bank Capital Programs	250	245	192	78%	26.8
Automotive Companies	82	80	11	14%	2.6
AIG	70	48			
Credit Markets					
Public Private Investment Program	22.4	14.2	0.43	3%	0.2
Term Asset-Backed Loan Facility	4.3	0.1			
SBA 7a Securities Purchase Program	0.4	0.4			
Community Development Capital Initiative	0.8	0.6			
Treasury Housing Programs*	45.6	0.5	n/a	n/a	n/a
Totals	475	388	204	53%	30

Source: Office of Financial Stability, U.S. Department of the Treasury. *Troubled Asset Relief Program: Two Year Retrospective.* Pg. i

[7] Original concept was a fund to purge the banks' balance sheets of illiquid assets, which proved to be unworkable. Switched to direct infusion of capital. Application of the "Stress Test" to bank balance sheets: If inadequate liquidity, the bank was required to raise private capital.

[8] AIG: Public villain for its reckless derivatives operation. US Government provided liquidity to AIG as well as its counterparties (e.g., Goldman Sachs and a number of European banks). AIG announced a restructuring plan permitting the Treasury's shares of AIG to be converted into common stock with the intention of being sold. The TARP figures for AIG do not include approximately $20 billion currently owed to the Federal Reserve through its revolving credit facility.

Trade Policy Measures:
The Protectionism that Did NOT Happen.

- Vocal fears of a replay of 1930s protectionism
- Expectations of large increase in trade remedy petitions.

Surprise: No Surge in Antidumping or CVD Cases in the United States or Elsewhere

- OECD concluded that protectionist measures
  - "do not play a significant part in explaining the fall in trade – only about 1% of world imports were affected by new trade restricting measures."[9]

- WTO:
  - "Despite the severity of the global financial crisis and its widespread impact on economies around the world, governments have largely resisted resort to trade barriers."[10]
  - "The first four months of 2010 have shown a significant cooling-off of trade remedy use."[11]

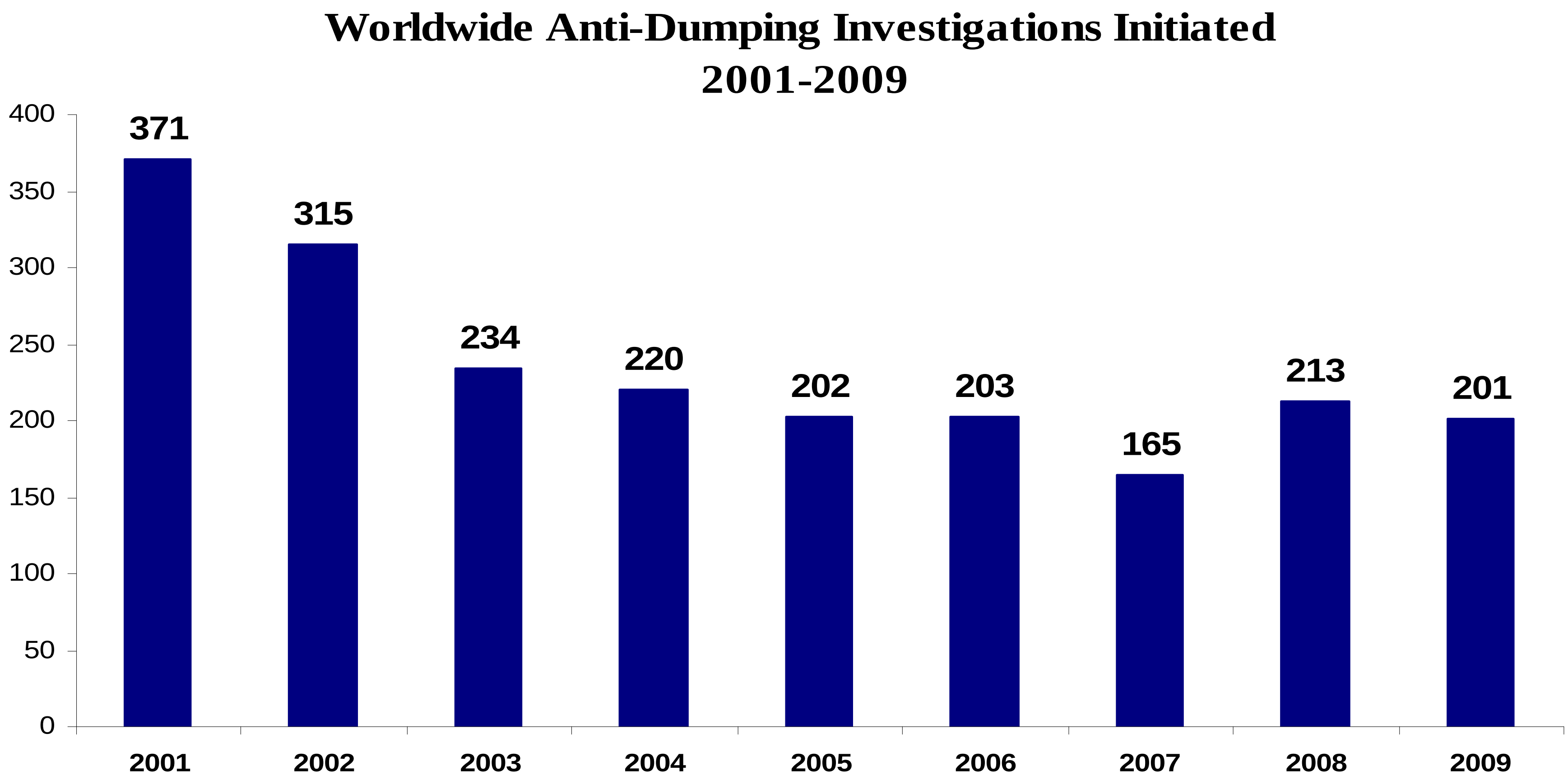
- <u>Decline</u> in proportion of global imports subject to import restricting measures and investigations.
  - October 2008 to October 2009: 1.01%
  - November 2009 to May 2010: 0.40%.

[9] OECD, *Trade, Policy and the Economic Crisis*, May 2010, p.1

[10] WTO, Report of the TPRB from the Director-General on Trade-Related Developments, Trade Policy Review Body, WT/TPRO/OV/W/3, June 14, 2010, p. 1.

[11] Id., p. 17.

Number of new antidumping investigations, as tabulated by WTO



WTO. Statistics on Antidumping initiations: by reporting member.
http://www.wto.org/english/tratop_e/adp_e/adp_e.htm

Top 15 countries imposing new antidumping measures in 2009 [12]

- Developing countries imposed the largest number of new measures.
- China was by far the primary target. United States was a distant second.

Country Imposing AD	2009
India	31
Argentina	28
Pakistan	26
United States	20[13]
China	17
European Union	15
Australia	9
Brazil	9
Canada	6
Indonesia	6
Turkey	6
Colombia	5
Panama	4
Peru	4
South Africa	3

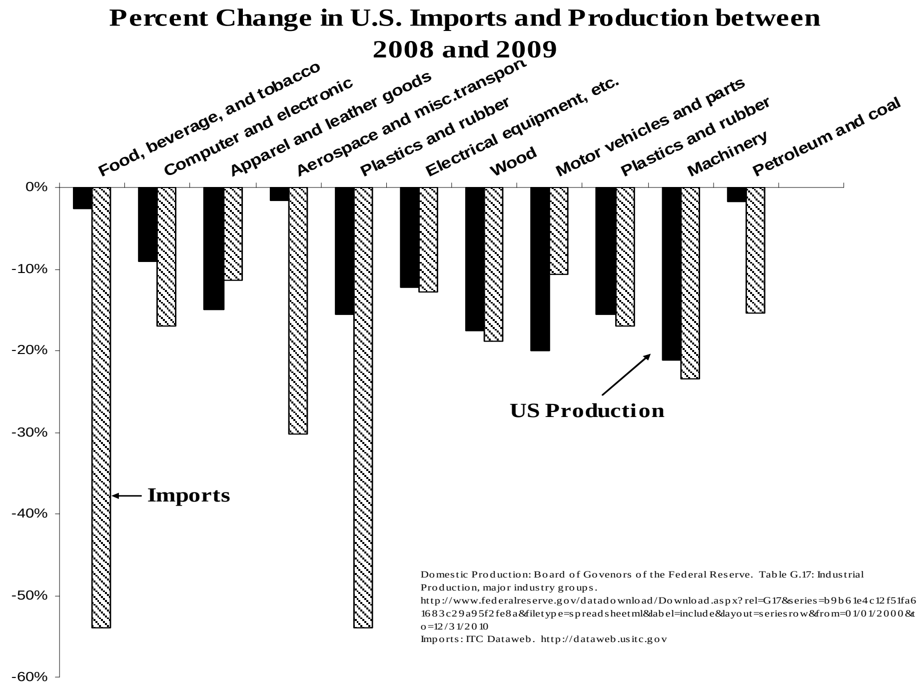
Target Country	2009
China	77
United States	14
Brazil	11
Taiwan	11
Indonesia	10
Thailand	8
India	7
Korea	7
Malaysia	6
Japan	5
Mexico	5
Russian Federation	4
Belgium	3
European Union	3
Germany	3

[12] WTO. Statistics on Antidumping Investigations: By Reporting Member and Exporting Country. www.wto.org/english/tratop_e/adp_e/adp_e.htm

[13] Success Rate for U.S. Title VII AD and CVD cases at ITC 1980-2007: (i) Preliminary investigations: 80% affirmative, 20% negative and (ii) Final investigations: 66% affirmative, 34% negative. US ITC, Import Investigations: Case Statistics (1980-2007), 2008.

Why No Widespread Protectionist Response?

- Example of United States:
  - In a number of sectors, U.S. imports declined as fast or faster than domestic industrial production. Result: a steady or declining import market share.
  - Reluctance to bring cases because of (i) global supply-chain linkages and (ii) vulnerability to import interests of large customers



- Some U.S. companies said that they were so short of cash that they could not afford to bring a case.

IX. The Future

- Global Trade Is Recovering:
    - World GDP to grow by +3.0% in 2010, compared with decline of -2.2% in 2009 (WTO).
    - 2010 projected growth in merchandise trade of +13.5% (faster than previously expected, but from a depressed base), after unprecedented fall of -12.2% in 2009.
    - Better understanding today of continuing vulnerability of trade to global declines in GDP.

	2007	2008	2009	2010 Projected
Volume of Merchandise Exports, % Change				
World	6.5	2.2	-12.2	**13.5**
Developed Economies	4.8	0.8	-15.3	11.5
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Developing Economies & CIS	8.0	5.7	2.0	5.9

Future Trade Actions

- Potential legacy of bailouts and stimulus spending in fostering new CVD actions, especially among industrialized countries:
    - To what degree would they qualify as countervailable subsidies?
    - Auto sector as possible prominent target.

China in the Bull's Eye:

- Chinese exports Are recovering faster than other countries' exports
- During 2010-Q2, world exports increased by 7% over prior quarter, but Chinese exports grew by 23%
- Became world's leading exporter in 2009 (9.6% global share), passing Germany (9.0%).
- China likely to remain the primary target of trade actions by industries in the United States and in other countries

[14]WTO, Trace Value Still Up by About 25% in the first half of 2010, Press Release, September 1, 2010.