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The Global Downturn and Trade Prospects for Small States

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Background

The current global financial crisis has not spared developing countries, for whom international trade has been a key transmission mechanism, linking them to markets that are heavily affected by the economic downturn via adverse terms of trade shocks and reduced demand for exports. This is more so for small states, which are heavily dependent on trade and on external flows in general (including remittances and foreign direct investment). Moreover, their exports tend to be more concentrated than those of other developing countries. This combination of factors makes small states more exposed to the vagaries of external markets. This issue of Commonwealth Trade Hot Topics sheds some light on the actual and possible effects of the global economic crisis on trade in small states, specifically focusing on the 32 states classified as such within the Commonwealth.[1] Given the dependence of these countries on trade, a large part of their resilience to this crisis will have to do with the way trade prospects are affected. Identifying the countries and the sectors which are more likely to suffer from the adverse trade-related consequences of the crisis is instrumental in designing the possible policy responses.

How the effects of the global financial crisis may play out via trade

The major trade-related effects of any financial and economic crises are displayed via countries' exports. In general these are adversely affected by three sets of factors: first, lower demand for goods and services due to decreasing income and worsening expectations (which influence demand for capital goods); second, drying up of credit availability (which affects both demand and supply of traded goods and services); and, finally, rising protectionism that makes imports relatively more expensive than domestic production. These factors are likely to be responsible for the recent collapse in trade that has already emerged in the data.

How is small states' trade likely to be affected in this context? Let us briefly describe the characteristics of their trade to answer this question. Due to the tiny domestic market, most of the firms in small states are small and medium enterprises with limited opportunities for reaping the benefits of economies of scale and investing in research and development.

[1] These are Antigua and Barbuda, The Bahamas, Barbados, Belize, Botswana, Brunei Darussalam, Cyprus, Dominica, Fiji Islands, The Gambia, Grenada, Guyana, Jamaica, Kiribati, Lesotho, Maldives, Malta, Mauritius, Namibia, Nauru, Papua New Guinea, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Samoa, Seychelles, Solomon Islands, Swaziland, Tonga, Trinidad and Tobago, Tuvalu and Vanuatu. Despite the focus of being on the Commonwealth small states, the implications of the work are likely to apply to most other countries as well with similar characteristics.

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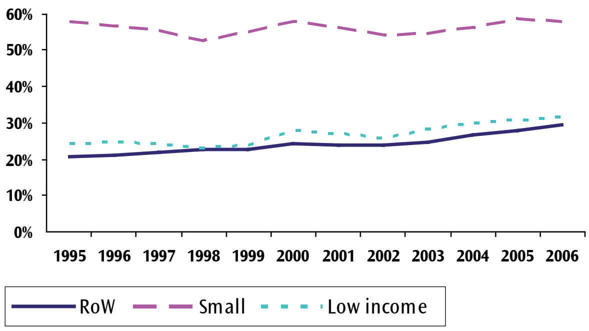
Figure 1: Exports of goods and services (% of GDP)



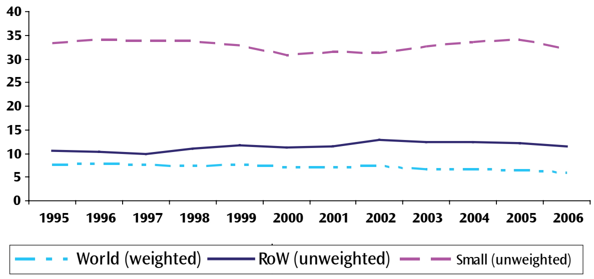
Source: World Development Indicators (2008)

Also, most small states lack skilled labour or adequate human capital, which limits their access to external capital and constrains industrial development. These factors contribute to high unit production costs for firms in these countries, which are compounded by high transportation costs due to the remoteness and insularity of many small states. This implies that small states need to charge higher prices to stay in business or else accept lower returns on some part of their costs as compared to larger economies. Winters and Martins (2005) calculate the income penalties suffered by many small states to be so large that exports in a free trade regime would be virtually impossible for them in a large variety of sectors.

Such high (average) penalties have three important implications for our discussion. First, small states tend to have a lowly diversified production structure, with most exports concentrated in a few sectors, and a large number of products and services acquired from abroad. For most of these economies, the combined share of the first and second commodity/service exported is over 50 per cent of total exports of goods and services. While openness facilitates specialisation and increases productivity of the domestic industry, it also makes these countries more vulnerable to sudden shifts in international demand. Figure 1 shows the higher dependence of small states on foreign markets relative to the rest of the world. Although such dependence (measured as share of exports in GDP) has been declining relative to that of the other countries, it is still twice as large as that of the rest of the world and low-income countries. Second, small states tend to rely more than other countries on external assistance, including trade preferences, aid and remittances. This dependence could make small states even more vulnerable in times when these other external flows may be adversely affected.

Third, small states specialise in services relatively more than in goods exports, although merchandise still accounts for most of their trade. Small states are generally net importers of goods and net exporters of services. This specialisation follows the fact that the penalties of smallness and remoteness are generally less severe for services than for goods exports. Tourism represents the most important part of services trade in the majority of small states. The share of tourism in total exports in small states is well above that in the rest of the world (Figure 2). There is, however, a large variation between small states in the degree of their export dependence on tourism. While tourism represents well above half of total exports (with St Lucia and Barbados being the most dependent), for other small states the size of the tourism industry is negligible, representing less than 5 per cent of total exports (such as in Papua New Guinea and Swaziland).

Figure 2: Tourism receipts as % of total exports



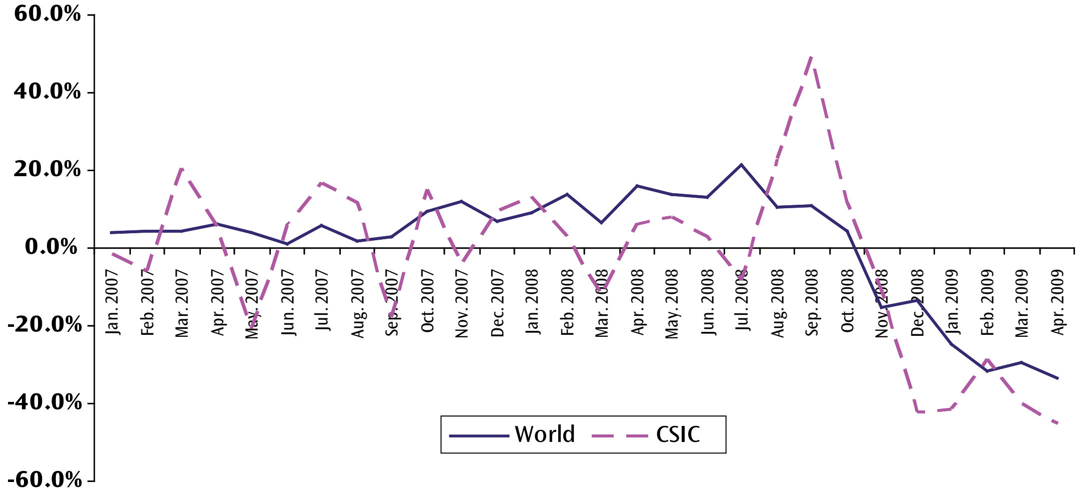
Source: Authors' estimates based on World Development Indicators (2008)

The discussion suggests that small states are potentially vulnerable to trade shocks as their dependence on trade is higher relatively to other countries, and their economic base and thus their exports are undiversified. Let us turn to the evidence on the actual and likely effects of the crisis in more detail.

The effects on trade in goods

The combined effects of the channels presented above appear to have already caused a substantial drop in goods exports. Figure 3 shows the fall in year-on-year monthly imports into the USA from small states and from the world as a whole. The drop in imports from small states (starting in October 2008) appears to be larger than that for total US imports, although it came after a spike in September 2008. Similar, albeit slightly more moderate, drops in imports have occurred also in the European Union. Overall, small states' merchandise exports seem to be affected by the global economic slowdown at least as much as other states. In order to identify

Figure 3: Average monthly year-on-year change of US imports from different sources (% change)



Note: Based on average daily imports in each month
Source: Derived from data obtained from USITC Interactive Tariff and Trade DataWeb

the possible effects at a more disaggregated level, it is useful to analyse what these countries are exporting and to what markets.

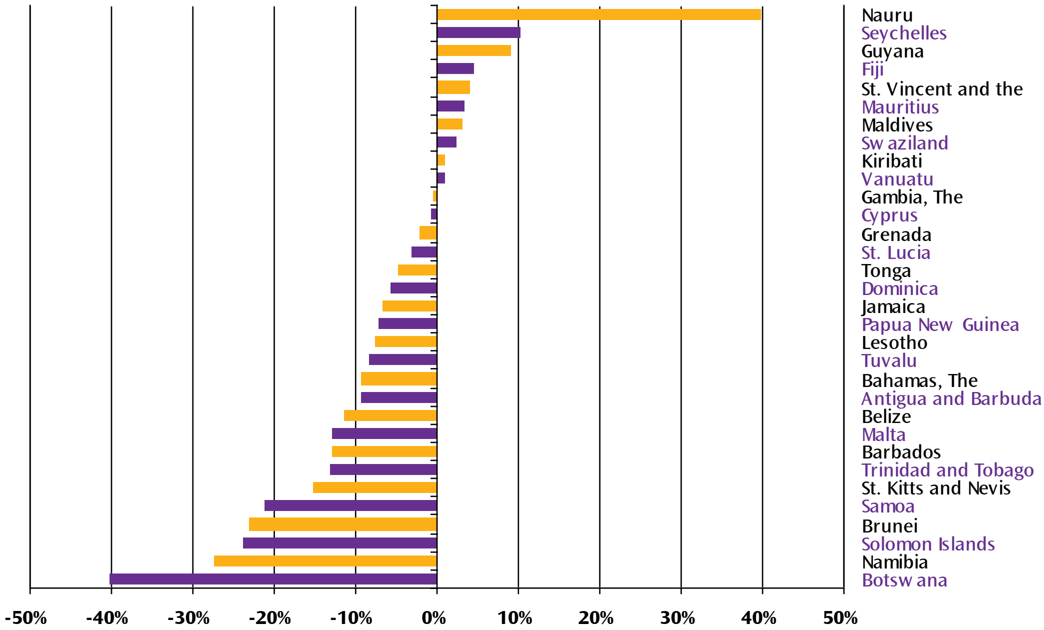
We draw a list of small states' major exports of merchandise items accounting for more than two-thirds of their total merchandise exports (42 sectors in total). In terms of value, these exports are concentrated in minerals, including oil, gas and precious stones. But the majority of countries are not rich in minerals, but rather export agricultural goods (such as food and live animals related products, and crude materials except oil). We use EU and US changes in imports over the last six months to provide a rough estimate of the effects of the global financial crisis on these exports, as these two markets represent a substantial share of total demand in all sectors. According to these data, minerals and fuels are the most affected categories (except for gold), followed by manufactured goods, especially agro-industry, and then agriculture. We then match these sectoral results with the sectoral composition of countries' exports computing an indicator of merchandise trade resilience for each of the small states. According to this computation, merchandise exports of most small countries should drop although the variation is significant (see Figure 4). Mineral and fuel exporters such as Botswana, Namibia, Brunei Darussalam, and Trinidad and Tobago should be particularly badly affected.

Along the same lines we also compute an indicator of trade resilience (TR) based on small countries' export markets and their expected performance. This is based on the idea that potential demand for a country's exports is driven by its trading partners' income as well as its types of exports. Figure 5 presents the results of the index computation in terms of expected variation in merchandise exports. All small states except Solomon Islands are predicted to have a negative export growth in 2009 according to this export market based index. This follows the fact that all their major importers have negative projected rates of growth for 2009. The relative resilience of Solomon Islands is due to the effect of China, which accounts for around half of the country's exports and which is predicted to grow substantially even in 2009.

Trade in services

Unlike trade in goods there is little recent systematic data on trade in services that can be used to predict the impact of the global economic crisis on services exports for small states. Given the relative importance of services exports for small states we try to provide some sense of the possible effect of the global financial crisis on these exports by resorting to indirect evidence. Borchert and Mattoo (2009) provide some suggestive evidence of the resilience of services trade relative to goods trade. The drop in US services imports growth between October 2008 and April 2009 has been around four times smaller than that of goods imports. However a wide variation of patterns emerges within the services categories, at least as far as US imports are concerned. Transport, travel and financial services exports appear to be paying a larger toll to the global downturn than the rest of the services sectors. Using this distinction between services sectors we can draw some inferences on the possible resilience to the crisis of services exports by small states.

Figure 4: Projected changes in exports on the basis of sectoral composition



Source: Authors' elaboration (see main text)

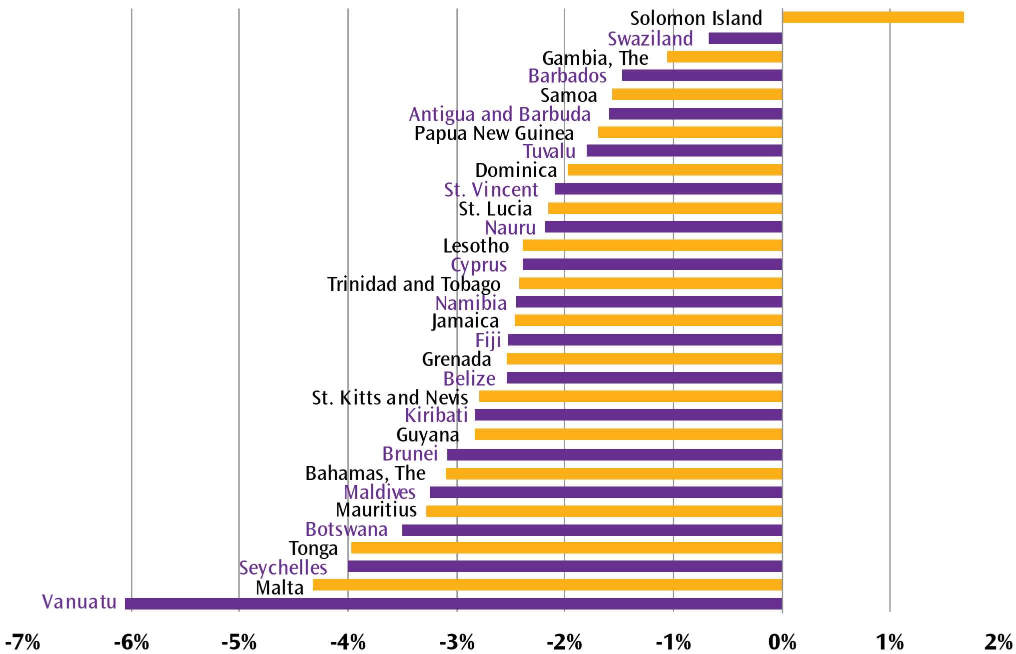
We classify small states according to their shares of less resilient exports in total services exports (that is, transport, tourism and financial services). Figure 6 provides the list of small countries ranked in decreasing order of this share. These sectors represent most services exports in the majority of small states mainly because tourism is such an important export for a lot of them. In particular, small countries in the Caribbean and the Pacific (with important exceptions such as Papua New Guinea) are especially vulnerable to the effects of the global downturn on their services exports. And those small countries with a high share of tourism in services exports are also those which export most services. Thus, their economies may be particularly vulnerable to the decline in tourism exports associated with the global financial crisis. The main exception to this rule is Namibia, which has the second-highest share of less resilient services exports (due to tourism) but for which these exports account for only a small fraction of its economy.

How do trade effects impact on the domestic economy?

The extent to which these trade effects will impact on GDP growth and development is a very different and much more complex question altogether. In general, other things being equal, the effects on the economy will obviously be larger the higher the dependence of a country on exports. But other characteristics matter as well, such as the share of value added in total exports (that is, how much of the value of the export is retained in the economy), the distribution of the value across factors of production, the level of employment dependent on exports (both directly and indirectly), and so on. It is beyond the scope of this study to explore these linkages in greater detail; however, it is worth examining the potential size of the trade channel of the crisis on the economy as a whole. We do so by using the share of goods exports in GDP and the share of less resilient services (as defined above) in GDP. We then use these shares and the trade effects of the crisis computed above to estimate the possible direct impact of the trade channel of the crisis on GDP. Figure 7 presents the results (as a share of GDP), which also represents a sort of summary of the various other estimations undertaken.

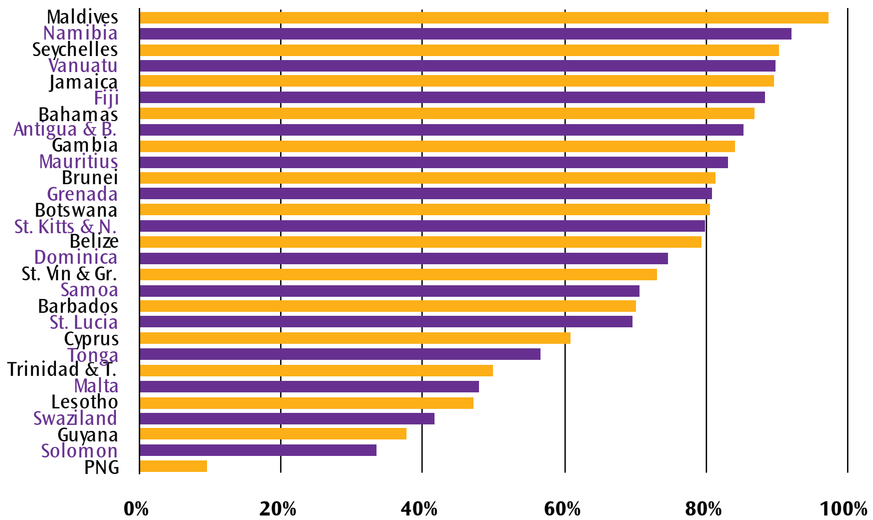
Most small countries are predicted to have fairly sizeable negative effects from the drop in exports induced by the global economic downturn. The only countries which are expected to have non-negative effects are Swaziland and Guyana, due to their dependence on basic agricultural exports such as sugar, rice and essential oils and low reliance on affected services exports. At the other end of the spectrum countries heavily reliant on minerals and fuels, like Botswana and Brunei Darussalam, are supposed to be the most negatively affected ones. Also, small states heavily reliant on tourism, such as Malta, Maldives and most Caribbean and Pacific countries, are likely to be particularly penalised. Exceptions do exist to the rules assumed by these predictions, as the case of Vanuatu's tourism resilience shows. To our mind this exception rather

Figure 5: Projected changes in exports on the basis of the export market composition



Source: Authors' elaboration (see main text)

Figure 6: Share of less resilient services in total services exports



Source: UNCTAD (2009)

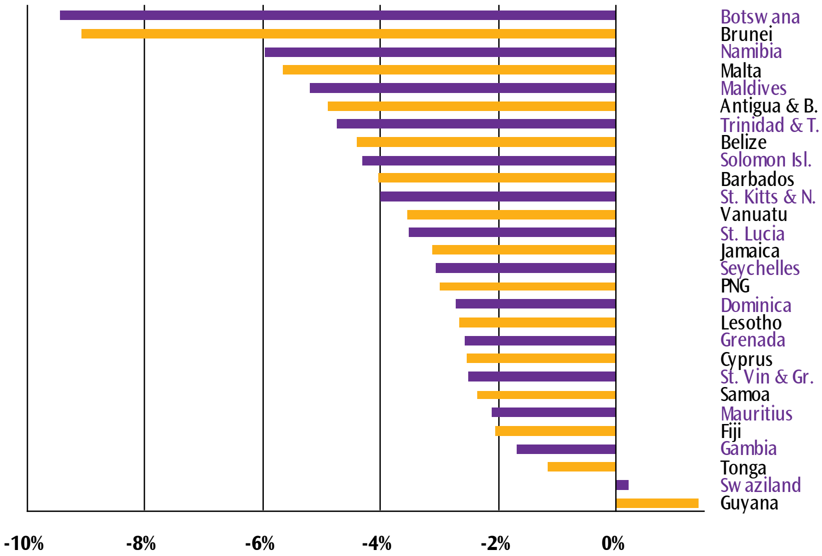
than calling into question the projections presented illustrates the possibilities of countervailing (to some extent) the negative effect of the crisis.

Policy implications

A major finding of this paper is that small states are likely to see their exports reduce fairly substantially, and for some of them the reduction may be critical. The wide variation in trade effects is related to the export composition of countries in terms of both markets and sectors. It is clearly more difficult to change the sectoral specialisation of a country than its trading partners, especially for a small state. In this context, diversifying the markets for exports is a strategy with a high return in times of crises. Often, however, small states have been locked in to export to certain markets via preferential schemes, the most important being the ones with the EU covering a number of agricultural products. Moving away from this preferential system is likely to facilitate the market diversification process.

In the short run, small states are constrained in the policies they can implement to limit the adverse effects of the crisis on exports. A first possibility is to use the exchange rate policy by devaluing the domestic currency vis-à-vis that of the major competitors in order to improve the competitiveness of the country's exporters. However, the scope of this measure is often constrained by pegged and semi-pegged exchange rates that small states adopt.

Figure 7: Possible trade channel effects of the crisis on GDP (% of GDP)



Source: Authors' elaboration (see main text)

Moreover the devaluation would also increase the price of imports and the costs of external debt.

Another possibility is to use the fiscal policy to stimulate exports by reducing (or eliminating) both explicit and implicit (for example, via import taxes on inputs) forms of export taxes. A measure of this type appears to have yielded some success in the case of Vanuatu, which recently scrapped the fee charged to cruise ships to dock in the port. This seems to have contributed to the recent increase in tourist arrivals via sea. In general, all measures that could reduce the costs of trading may be particularly effective in a period of price sensitive international demand. Trade facilitation activities may help in reducing these costs in the short run, and have proven to be particularly effective in decreasing the costs of exporting in small vulnerable economies, or SVEs (Calì and te Velde, 2009). Infrastructure upgrading and development are possibly more effective at reducing trading costs but are more long-term measures. In some cases the latter measures could represent an effective way of implementing counter-cyclical fiscal stimulus packages in countries.

One of the major factors responsible for the fall in trade has been the lack of general credit, of which trade finance is one part. This tends to constrain especially those firms that lack assets (and thus guarantees), for which producing and exporting (or import competing) becomes increasingly difficult. Ensuring access to credit particularly to such firms may help limit the fall in exports and in some cases preserve the existence of domestic industries.

The crisis has also had a negative effect on the prospects of the offshore financial centres, which have come under closer scrutiny. This may explain in part the drop in financial services imports by the USA and could suggest reorienting existing offshore centres, which are present in a number of small states, to offer more sustainable types of financial services.

Finally, all the efforts of the international trade community to minimise the impacts of the crisis on international trade would be particularly beneficial for small states given their high degree of openness and dependence on international trade. Such international policy responses could include the fight against any forms of trade protectionism, the provision of adequate funds and guarantees to ensure sustained trade finance, and the provision of aid for trade towards effective areas of intervention.

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