The Normalization of Global Trade and China

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Over the past five years, global trade and global production have grown at similar rates, whereas before 2008, global trade grew at twice the rate. This slowdown in global trade is largely due to China's rebalancing towards its domestic demand and its services sector. If we exclude the decline in trade related to increasing protectionism, near-parallel growth for global trade and production is the new "normal."

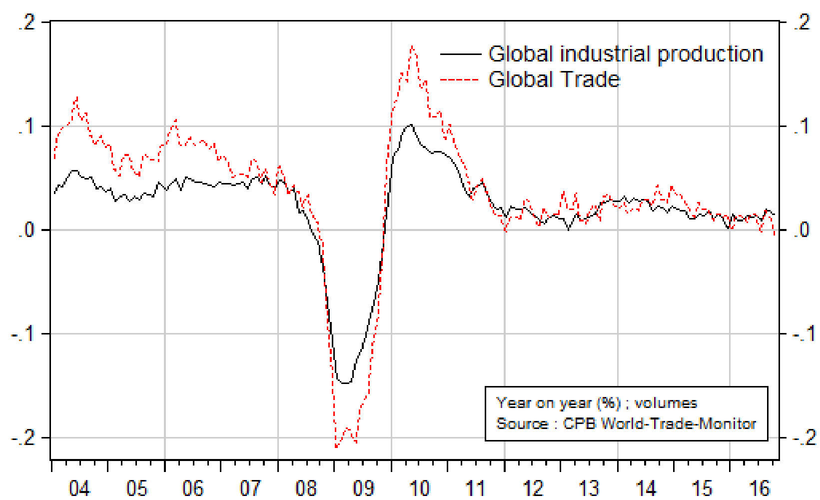
There are concerns that this slowdown in global trade could continue. Chart 1 shows that the pace of global trade growth (red line) has followed that of production (black line) since 2011. Since the great recession, growth in global trade and global production was the slowest in 2015 and 2016, which is why many have sounded alarm bells. These concerns have been amplified by trepidation about the consequences of the referendum in the United Kingdom and the US presidential election.

Factors behind the slowdown in global trade

Recent studies cite several cyclical or structural factors to explain this slowdown in supply and demand. For example, the role played by weak global demand has been highlighted in analyses by the IMF and, more recently, the Bank of England. In fact, global trade is procyclical. The most volatile components, particularly business investment, account for a larger portion of demand than they do for total activity. As Sébastien Jean (CEPII blog, 10/18/16) stresses, however, sluggish global demand would explain only a third of the observed slowdown. Most importantly, the drivers of this weakness are not only cyclical — structural changes to global demand and supply are underway.

All of the analyses, in particular within the Eurosystem, draw attention to the globalization of production processes or the fragmentation of global value chains (GVCs). The remarkable development of GVCs over recent decades sets the stage for stabilization and an eventual downturn. According to Timmer et al. (2016), this fragmentation stopped in 2011, when demand shifted to the services sector, notably in China. The OECD has presented other structural explanations, such as weak potential growth and investment, trade policy and, once again, the specific role of China. The latter would be the most significant driver since 2015 and is the focus of this post (and in our Rue de la Banque article from September). **The Chinese supply shock contributed to the acceleration of global trade before the crisis. The rebalancing towards domestic demand contributes to the trade slowdown and to a new normal, in which global trade and global output grow in parallel.**

Chart 1: Sluggish world industrial production and trade



Closing the chapter on highly dynamic global trade

Notwithstanding larger temporary shocks, the rate of growth in global trade cannot permanently depart from that of global production. This is a logical necessity and an empirical fact (as it is argued in our Rue de la Banque). Reducing trade barriers, for example, increases the level of openness and growth in global trade as it transitions toward a new equilibrium. Following each shock, however, the trade-output elasticity, i.e., the ratio between trade and output growth rates, returns to equilibrium (1).

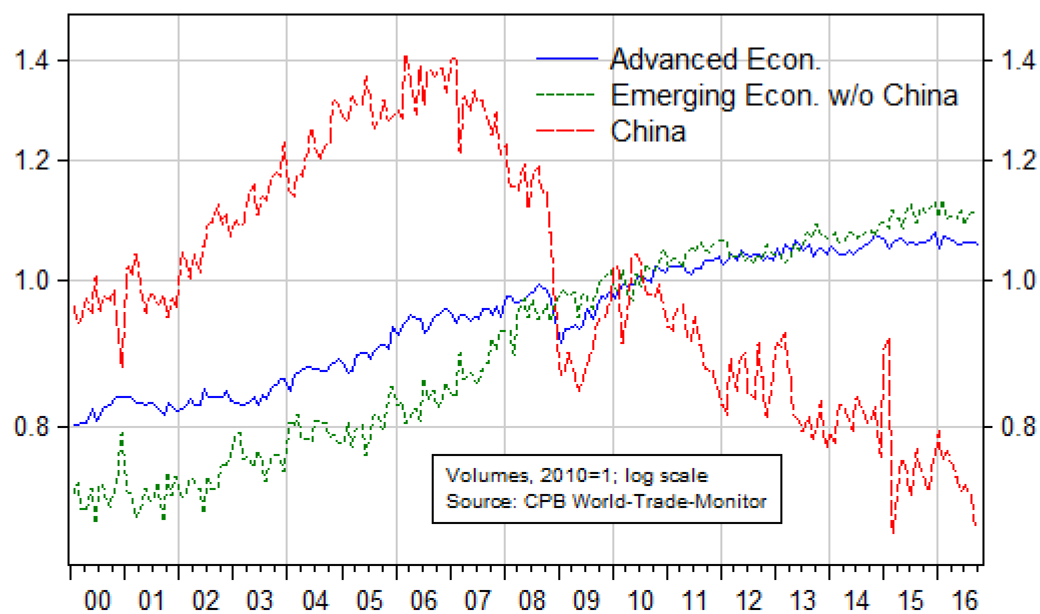
Over the past two decades, China has been the catalyst of such shocks. The emergence of China in the global economy and the fragmentation of GVCs are connected. GVCs were often developed by taking advantage of great opportunities in China to localize tasks that require intense labour and low or medium skills. Furthermore, trade liberalization improved and secured Chinese producers' access to the global market, multinational firms also gained access to the Chinese market (particularly to intermediate goods with high added value). With China's admission to the World Trade Organization in 2001, the supply of Chinese labour in the globally traded goods sector has put downward pressure on the price of manufactured goods (boosting the increased global demand for consumer electronics, for example; see chart 3 in our Rue de la Banque). At the same time, Chinese demand has contributed to a rise in the cost of raw materials, generating an increase in import expenditure of commodity producing countries (see post by Daniel Gros, 10/11/16 and speech given by J.H. Powell of the Federal Reserve System Board of Governors, 11/18/16).

Toward a normalization of China's openness

Several factors combined to normalize China's openness to the world: fewer opportunities abroad; higher wages; diversified supply and demand; and rebalancing of China's growth model to domestic demand, including real appreciation of the exchange rate between 2005 and 2015. Given the production shift toward the services sector, China's impact on prices has lessened or reversed.

Chart 2 shows that China's export openness (red) has dropped sharply since 2007, while that of advanced economies (blue) and emerging-market economies (green) did not experience a similar drop. Evidence related to import openness is the same.

Chart 2: There has been a significant drop in China's export openness since 2007



China is moving toward a level of trade openness that is more in line with that of large countries. This normalization completes the exceptional phenomenon of hyperglobalization. Outside of another significant shock to trade openness, the rate of global trade growth should now remain close to global production growth. It is also possible it could be lower should developments in the United Kingdom or the United States result in shocks from reduced trade.

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Just two references

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2. Gaulier G., W. Steingress & S. Zignago (2016), "The role of China in the trade slowdown", Rue de la Banque #30, Banque de France, September.