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## THE ROLE OF TRADE IN THE GLOBAL ECONOMIC CRISIS: THE CASE OF THE EUROPEAN UNION

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**Abstract:** *For international trade to flourish, it is essential to have a well functioning financial system, which provides vital capital for trading activities and insures against trade-related risks. Financial crisis, as evident in this moment, can cause great economic and social damage which affects trade in terms of raising the costs of essential financial services while reducing their availability and more indirectly through the decrease in aggregate demand. This article will explore the numerous and complex links between trade and the financial sector giving an insight into the European Union's trade policy in the light of the global economic crisis. Although its' export growth was expected to deteriorate by more than two-thirds from 2007 to 2009, the European Union is expected to keep contributing to the key role of trade in curbing the current economic slowdown. This article will also give further recommendations on the importance of the role of trade and adequate trade policy in preventing and suppressing economic shocks.*

**Key words:** *international trade/ European Union/ financial crisis/ trade policy/ liberalization.*

### INTRODUCTION

Up to this moment, the world has suffered three major financial crises in the last ten years: the European Monetary System (EMS) crisis in 1992-1993, the Mexican crisis in 1994-1995 (which spread to a number of South American countries) and the Asian crisis in 1997-1998. The start of the current financial crisis was triggered in the summer of the year 2007 by the realization that the risks associated with the US market for sub-prime mortgages were not properly reflected in the price of related instruments, particularly mortgage-backed securities. A market-wide rea-

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assessment of financial risk led to a sharp increase in the number of premiums and spreads across all segments of the credit market.

As pointed out by González-Páramo (2009), tensions in the markets for credit instruments spread to the money markets in early August 2007, which led to the exceptionally high uncertainty about potential direct exposures of banks to "toxic" assets and increased demand for liquidity. Lack of transparency about the extent of exposures compounded uncertainty, preventing market participants from distinguishing good banks from bad banks. Money market interest rates and spreads rose sharply, while liquidity dried up, prompting central banks to intervene through large-scale liquidity injections.

In March 2008, the Fed had to rescue Bear Stearns, which was then the fifth largest U.S. investment bank, by JP Morgan and grant direct access to its financing to the other main investment banks for the first time since the Great Depression. The financial turmoil deepened in the weeks following the collapse of the Lehman Brothers in mid-September 2008. Within two weeks since the bankruptcy of the Lehman Brothers, mounting losses from the sub-prime mortgage markets resulted in the fact that both the US largest insurance company (AIG) and the largest savings and loan institution (Washington Mutual) were seized by the government.

Currently, financial markets are in the state of severe crisis that has started to spill over to the real economy. Policy makers around the world work to restore confidence in the financial system. In 2008, volatile commodity, food and energy prices and the weakening of the dollar against the euro have influenced economic developments. Global trade finance activity was influenced by events in the financial markets and, consequently, trade flows were rapidly and substantially affected. World trade activity was expected to fall in 2009 which would have been the first annual decline in global trade since 1982. The tension in the market is reflected in the Baltic Exchange's Dry Index, a measure of the cost of moving raw materials by sea (more than 80 percent of international trade in goods is carried by sea), which fell to a nine year low in November 2008, 11 times lower from its record high in May 2008.

The credit crunch can affect both exports and imports to the point of stopping. The availability of short-term trade finance in such periods has therefore become a major concern of the international financial and trading communities worldwide. This article describes the nature of the problem faced by the international trading community, focusing on the case of European Union, and examines the modality of adequate trade policy support during the current crisis.

## TRADE AND FINANCIAL CRISIS

Financial crisis can bring about great economic and social damage, as shown by numerous crisis episodes. It can also hurt trade through raising the costs of essential financial services and reducing their availability and, more indirectly, through depressing aggregate demand which is reflected in a World Trade Volume annual change in Table 1.

Table 1. World Trade Volume annual change (%)

|     | World Trade Volume annual change (%) |      |      |
|-----|--------------------------------------|------|------|
|     | 2007                                 | 2008 | 2009 |
| IMF | 7.2                                  | 4.1  | -2.8 |

Source: IMF (2009)

When analyzing the links between financial crisis and trade policies support, the multilateral trading system cannot be seen in isolation from other domestic and international economic issues, such as prudential regulation, macroeconomic stability and the international financial architecture.

The International Chamber of Commerce has outlined that the global trade slowdown has been linked to several contributing factors:

- "slowing of demand from OECD buyers of Asian goods;
- Higher losses by trade banks due to deterioration in credit quality, fraud and commercial disputes;
- Rapid fluctuations in commodity prices;
- Foreign exchange rate volatility;
- Increased counterparty risk aversion which results in significantly higher risk pricing (confirmation commission/discounting etc.); and
- Lack of US dollar liquidity which also results in significantly higher borrowing costs (resulting in high liquidity premiums as well as risk premiums)" (p. 21).

The availability of credit and a number of trade-related financial instruments is vital for support of international trade. The availability of trade finance, particularly in times of crisis, plays a crucial role in facilitating international trade. Exporters with limited access to working capital often require financing to process or manufacture products before receiving payments while importers need credit to buy raw materials, goods and equipment from overseas.

In a times of crisis, the government steps in and increases their support for export insurance (official export credit) provided by export credit agencies (ECAs). Stephens (1998) analyses the role of trade financing and related government policies in preventing and coming out of crisis. Export credit agencies, government guarantees, or central bank schemes to secure trade financing and working capital can be useful complements in times of financial sector turmoil and disruptions in orderly trade financing.

In a discussion paper by WTO (2003) the following variables were identified to have a direct impact on macroeconomic decline:

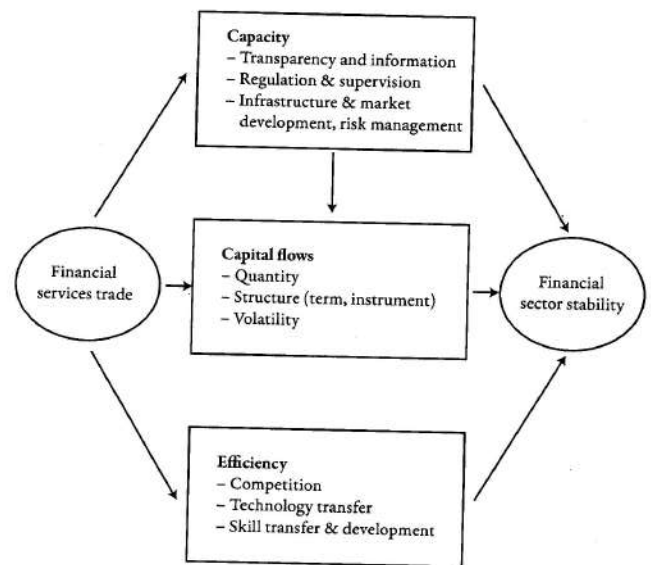
- 1) "large swings in exchange rates which have exacerbated the fundamental weaknesses (financial fragility, external vulnerability, and poor governance) and created a vicious circle of depreciation of currencies bringing more financial institutions and their customers into insolvency, and further weakening confidence;
- 2) the scarcity of short-term trade-financing facilities (in particular the opening of L/Cs and subsequent confirmation). „Cross border” international trade finance for imports became a particular problem at the peak of the crisis. In light of a general loss of confidence in a local banking system, international banks forced up confirmation fees or inter bank loan margins, and reduced or cancelled „bank limits” as well as „country limits” (p. 4)

Kono and Schuknecht in Figure 1. (1999) discuss the importance of financial services trade policy for financial stability. The commercial presence of foreign service providers and liberalization across the full spectrum of financial services is particularly beneficial to financial systems. Such liberalization promotes competition and encourages the transfer of skills. Market and infrastructure development, risk management and transparency are increased. Finally, a better information base for investors and deeper and broader financial markets are likely to generate a more balanced maturity and instrument structure of foreign debt which is less conducive to financial crisis.

#### GLOBAL TRADE AND EUROPEAN UNION

The European Union has become one of the world's key economic engines, accounting for about 30% of global GDP and 20% of global trade flows, while the Euro has emerged as a key international currency. Starting as a free trade area of six members the EU with five waves of enlargement has expanded to become a federation of 27 sovereign states. By joining European Monetary Union, 15 countries have replaced their national currencies with the Euro and given up their indepen-

Figure 1: The Links between Financial Services Trade, Capital Flows and Financial Sector Stability



Source: Kono and Schuknecht (1999)

dent monetary policy to the European Central Bank. European macroeconomic policy regime is associated with the European Monetary Union with a clear division of tasks between the European central bank and national governments. The micro-economic policy regime consists of the internal market, the economic core of the EU, and its support policies in the areas of competition, trade and cohesion. The internal market relies on the Community with well defined roles for the Commission, the Council and the Parliament.

The process of integration has brought more variety to the Union and has required a set of policies to support it. The single market is the core of today's Union and the greatest achievement, now maybe comparable with EMU. The process started in 1985 with the fragmented economies of 12 Member States and now the internal market equals to 500 million citizens and over 20 million businesses.

When trade barriers were removed and national markets opened, trade became a major vehicle which enhances growth. Competition between imports and local products lowers prices and raises quality. The disappearance of trade barriers within the EU made a significant contribution to its prosperity, by increasing growth and employment. Since its beginning in 1992, the Single Market has created nearly three million new jobs. The Single Market program is supported by a range of supporting instruments: anti-trust/competition, trade, monetary and cohesion policies.

Under the Global Europe framework (2006) European trade policy has adapted to new priorities. Its aim is to focus manufacturing and export industries on sectors in which EU is internationally competitive, keep markets open to trade and focus resources on ensuring that others are open to trade with EU. As well as being a firm defender of the WTO and the Doha Round of world trade talks, EU has signed new free trade agreements with India, Korea and the South East Asian countries, established a close new trade dialogue with China. Thanks to some of its key assets such as chemicals, pharmacy products, motor vehicles and non-electrical machinery, the European Union's trade balance for manufactured products has improved reaching a surplus of €162 billion in 2007. EU has managed to maintain its world market share at 19.5% for merchandise trade (excluding energy), while the US and Japan now respectively account for 13.0% and 9.5% of the world market.

The EU's good performance compared to the United States or Japan is due to an upgrading of the quality of its products, combined with the ability of EU companies to sell products at premium price because of quality, branding and related services. These products now account for a third of world demand and represent half of EU exports, not only in luxury consumer goods, but across the whole range of products, including intermediary goods, machinery and transport equipment. Two thirds of EU imports from outside the EU are incorporated as inputs in the production process. This very high share of inputs in total EU imports, even when energy products are excluded, demonstrates very clearly that the EU as a whole relies heavily on global sources for inputs incorporated in its production process.

In the field of exchange of services, the EU is the leading exporter with 26.9% of the world market against 19.7% for the US and 6.1% for Japan. With regard to foreign investments, the European Union is the world's biggest investor and the principal host. When intra-EU stocks are excluded, the EU owns 33% and hosts 29% of world investment stocks.

### EU TRADE POLICY SUPPORT IN TIMES OF CRISIS

By the end of 2008 the EU economy was already in recession, with GDP falling by 1.4% in the last quarter of 2008 compared to a year ago. The downward trend continues into 2009 and industrial production in the EU has fallen to some 15% below that of last year. EU merchandise exports first dropped last November, by 11% year-on-year. In December 2008, the EU adopted an ambitious Economic Recovery Plan as the financial crisis began spilling into the real economy. The EU reacted to the financial turmoil in a rapid and coordinated manner, with the primary aim of stabilizing financial markets, unlocking credit flows, implementation of guarantee and recapitalization schemes for banks and other affected financial institutions.

In the context of a changing global environment, having the right internal policies and ensuring openness to trade and investment as well as greater openness are considered as critical and linked requirements for European Union trade policy. EU trade support measures are based on the commitment to open markets, recognition of the importance of trade and investment in order to help the economy escape from crisis, which is a key priority for Europe in the forthcoming months. EU support measures comply with strict state aid rules, with the European Commission monitoring national aid schemes to avoid potential distortions to competition. It is important to emphasize here that assistance is only allowed on a temporary basis and must be linked to restructuring plans.

The risk of protectionism should be kept to ensure that the rules of the single market are recognized and followed. Regarding intra-EU protectionist pressures, (for example the rescue package for the car industry proposed by the governments) there is no general trend toward protectionism among the EU27. However, there is great political awareness that this constitutes a risk. Evidence of this is the fact that presidency of the EU called for an extraordinary summit to discuss the issue of protectionism. World Bank, IMF and UN are also playing important roles in identifying and putting in place measures aimed at support of trade finance. Overall, developing countries have resorted more to border measures (e.g. Argentina, India, Russia, Indonesia) while in developed countries other types of measures are being used namely public procurement clauses (e.g. "Buy American" Clause) and subsidies (e.g. rescue packages for industries such as banking, cars etc.).

Trade Policy Review of the European Communities conducted by WTO Trade Policy (2009) underlines that there are no *Buy European* type requirements attached. The financial and fiscal packages of the EU are providing a stimulus to ove-

rall demand for foreign and domestic goods and services alike. Thereby, they are creating trade. There can be no mixing up of these stimulus programs with tariff or non-tariff measures that directly restrict trade. The EC has introduced none of these. On the contrary, EU has allowed unimpeded flows of imports and made active efforts to facilitate trade by stepping up official export credit and insurance to fill the gap in trade financing left by private banks. Yet, for trade to be part of the solution to the crisis, EU must ensure that the G20 commitment is respected and the DDA is finalized.

Very concrete commitments at the G20 forum in April 2009 on resisting protectionism and promoting global trade and investment were made:

- "within the next 12 months, the countries will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions or implementing WTO inconsistent measures to stimulate exports;
- the countries will minimize any negative impact on trade and investment of their domestic policy actions including fiscal policy and action in support of the financial sector. They will not retreat into financial protectionism, particularly measures that constrain worldwide capital flows, especially to developing countries;
- the countries will take steps to promote and facilitate trade and investment; and ensure availability of at least \$250 billion over the next two years to support trade finance through export credit and investment agencies and through the MDBs;
- the countries shall strive to reach agreement this year on modalities that leads to a successful conclusion to the WTO's Doha Development Agenda (DDA) with an ambitious and balanced outcome" (p. 6).

The current environment is fertile ground for protectionist pressures and the objective of EU trade policy is to keep global markets open and prevent a protectionist escalation which would make the situation even worse. This requires global political leadership and coordinated action. The situation must be monitored closely and the lessons from the past shall be taken in consideration as the global crises have been fertile ground for the emergence of protectionist policies which could only make the crisis worse for the whole world, not only the EU.

## CONCLUSION

The post-World War II era has been characterized by high growth rates in the world economy and a progressive reduction in barriers to international trade and

investment. Productivity increases in agriculture and manufacturing, and more recently in services, have become a major driver in the generation of income and wealth. There is massive empirical evidence that open economies are richer and more productive than closed economies. EC (2009) pointed out that "theoretical channels between openness and productivity are clear, as reallocation of resources, more competition, economies of scale, bigger variety of products, innovation, and knowledge spillovers" (p. 33).

Trade policy is a major European economic pillar. Free trade among the EU members underpinned the launch of the Union 50 years ago. Today Europe is the world's biggest exporter, accounting for 20% of global imports and exports, the world's biggest investor and the world's biggest market for foreign investment. Roughly one fifth of the world trade in goods and close to a third of the global services market belongs to EU, as it is the largest entity in international trade in goods and services.

This article has examined the role of trade and trade policy in preventing financial crises especially in regard to keeping open markets with adequate liberalization strategy and suppressing any kind of protectionism. In the case of European Union, financial instability can be increased through trade protection. If countries resort to restrictive trade measures during financial crises in a misguided attempt to protect their domestic producers, this gives rise to inefficiencies at home, and might worsen the financial position of exporters in other countries. The adverse effects of the Great Depression on output, employment and financial stability around the globe would have been much less severe if trade protection had not taken hold.

Fortunately, the lesson from the Great Depression—that protection is not a suitable policy response to crisis—seems to have been learnt. In the current crisis, open markets are to be maintained and the crisis resolution strategy even features significant trade liberalization. As the EU is facing a changing reality, it seeks to liberalize trade in a manner which promotes financial sector development, undistorted capital flows and transparency in the financial system, while also enhancing competition and efficiency in the financial sector. Depending on the EU liberalization strategy pursued, trade can promote both economic growth and financial stability and in these circumstances be part of the solution to the crisis.

## ULOGA TRGOVINE U GLOBALNOJ EKONOMSKOJ KRIZI: SLUČAJ EVROPSKE UNIJE

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**Sažetak:** Za procvat međunarodne trgovine esencijalan je finansijski sistem koji dobro funkcionise i koji obezbeđuje neophodan kapital za poslove trgovanja i obezbeđuje od rizika vezanih za trgovanje. Finansijska kriza, kako je vidljivo u ovom momentu, može izazvati veliku ekonomsku i socijalnu štetu koja pogada trgovinu kroz povećanje troškova esencijalnih finansijskih usluga uz reduciranje njihove dostupnosti i indirektno kroz snižavanje agregatne tražnje. Ovaj članak će istražiti brojne i kompleksne veze između trgovinskog i finansijskog sektora pružajući uvid u trgovinsku politiku Evropske Unije u svetlu globalne ekonomske krize. Iako se očekivalo da porast njenog izvoza uspori za više od dve trećine od 2007. do 2009., očekuje se da Evropska unija nastavi doprinositi ključnoj ulozi trgovine u obuzdavanju trenutnog ekonomskog zastoja. Ovaj članak će takođe pružiti dodatne preporuke o važnosti uloge trgovine i adekvatne trgovinske politike u sprečavanju i suzbijanju ekonomskih šokova.

**Ključne reči:** međunarodna trgovina/ Evropska unija/ finansijska kriza/ trgovinska politika/ liberalizacija.

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