PRESS POINTS FOR CHAPTER 4:

DO FINANCIAL CRISES HAVE LASTING EFFECTS ON TRADE?
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Key Points

- **Imports tend to decline sharply in the first two years after a financial crisis and remain depressed even in the medium term, according to 40 years of historical evidence. In contrast, exports are relatively unaffected.**

- **Countries with higher current account deficits tend to experience a larger reduction in imports. Imports also fare worse when the crisis is accompanied by greater currency depreciation, higher exchange rate volatility, and relatively weak credit conditions.**

- **Our findings suggest that imports in countries that recently suffered a banking crisis—which include the United States and much of advanced Europe—may stay below pre-crisis trends for several years. The reduction of their current account deficits in 2009 may thus prove long-lasting.**

- **They also imply that economies that have relied heavily on demand from the crisis-hit countries in the past will need to bolster domestic demand to support growth in the future.**

Trade is recovering well from the global downturn, but has not yet recovered the ground lost during the crisis. This is particularly the case in economies hit by a banking crisis. Because the recent banking crises occurred in economies that account for a substantial portion of global demand, the speed and extent of the recovery in their imports will have a significant impact on growth in their trading partners.

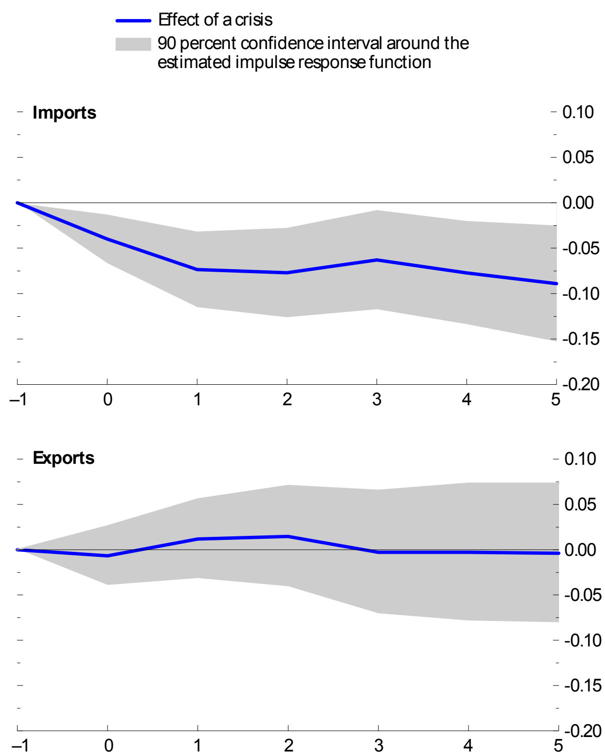
The chapter analyzes trade dynamics following past banking and debt crises to help us understand how trade might evolve in the wake of the recent global downturn. We look at 169 episodes of banking and debt crises in advanced, emerging, and developing economies over the past 40 years. We track the behavior of imports and exports after these crises, both to estimate the overall trade declines and to assess the associations of various factors—such as output and exchange rate dynamics—with trade.

We find that imports fall sharply after a financial crisis and remain below normal (that is, below their predicted level) even over the medium term, while exports are relatively unaffected. And it is not just because crises lower output; a number of other factors also explain the decline in imports. The decline in output accounts for roughly half of the post-crisis fall in imports. In the early post-crisis period, increased exchange rate volatility and currency depreciation contribute to the import fall. Over the medium term, poor credit conditions are also a factor. "Composition effects" may also play a role: during crises, demand for products that comprise a larger share of trade than of output experience a particularly large decline—for example, consumer durables or investment goods. This may be explained by the fact that demand for these goods relies heavily on credit, which is tight after a crisis.

Postcrisis Import and Export Losses, Controlling for Output

(Percent deviation from normal; years on x-axis; crisis begins at t=0)

Following a financial crisis, imports of the crisis country fall sharply and remain depressed, even after controlling for output. But exports of the crisis country behave no differently from normal.



Source: IMF staff calculations.
Note: Blue lines indicate the impulse response function – the effect of a crisis on imports and exports relative to what would be predicted in the absence of a crisis. Predictions are based on a collapsed gravity model in changes, with contemporaneous and lagged crises, home and trade-weighted partner output, a trade-weighted partner crisis dummy, and country and time dummies.

Our results imply that imports of many advanced economies will remain below pre-crisis trends for years to come. This has clear implications for emerging economies that have relied on export-led growth. The full recovery of import demand in countries that recently suffered a banking crisis—including the United States, the United Kingdom, and much of advanced Europe—may be more protracted than suggested by their tempered output projections. The recent narrowing of the large current account deficits of crisis countries may thus prove to be quite durable—which is consistent with the medium-term projections in the WEO. For economies that experience a crisis, the chapter underscores the importance of embracing structural reforms that support the recovery of output. For economies that have relied heavily on demand from these countries, our findings highlight the urgency of boosting the contribution of domestic demand to growth—so that their economies are fired by "twin engines".