Trade Collapses: the role of Economic and Trade Policy Uncertainty in the Great Recession*

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EXTENDED ABSTRACT: The sharp economic downturn in 2008 triggered the "great trade collapse" (GTC)— the largest worldwide trade contraction since WWII. Standard models are unable to fully account for either the depth of the collapse or its relatively fast reversal. The crisis also generated widespread fear of a global trade war. We examine if the resulting increase in policy uncertainty initially deepened the collapse and then helped reverse it, when the worst fears of protection were not realized. More generally, we use this episode to examine the role of institutions such as trade agreements as insurance mechanisms for policy uncertainty. We do so in three steps.

First, we characterize the trade dynamics of U.S. trade at the firm level before, during and after the crisis. Among other things we find that about 40% of the drop in U.S. export value during the collapse is due to a net exit of firms from trading.

Second, we develop a dynamic model with sunk costs of entry and exit into foreign markets where heterogeneous firms face demand uncertainty in both policy and economic conditions. The model predicts that the impact of economic uncertainty shocks on firm entry and exit is amplified if lower income is associated with higher trade protection, as was the case in the Great Depression and until recently. For example, the possibility of trade wars or rising protectionism were widely discussed at the start of the GTC. Agreements where countries credibly fix their trade barriers may reduce both the direct impact of trade policy uncertainty and dampen the effect of economic uncertainty.

Third, we construct measures of economic and policy uncertainty and estimate their impact on firms' entry and exit decisions. We find that uncertainty has a negative impact on the number of firm-product varieties exported by the US and that its effect increased during the GTC compared to the baseline period of 2002-2008. The negative impact of economic and policy uncertainty during the GTC is weaker for firms exporting to countries with which the US has preferential trade agreements

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(PTAs); this differential effect disappears by 2011. The impact of uncertainty for non-PTA destinations is stronger in industries where the importer has higher potential tariffs at the start of the crisis and then recedes. The findings are consistent with several of the models' predictions and indicate that (i) the Great Recession increased not just economic but trade policy uncertainty in non-PTA markets and both contributed to the GTC; (ii) PTAs insured against the negative effects of potential protectionism and (iii) the reversal in the expectation of a trade war contributed to the recovery.