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Economic Insights:
Slowdown in emerging market trade: a supply-chain perspective

Key takeaways

- The contribution of global value chain (GVC) participation in merchandise trade has levelled off since 2012.
- Maturation of the GVC means labour-cost arbitrage is no longer a prime consideration.
- This structural development points to the prospect of sustained weak trade growth in the coming decade.
- In this "new normal", emerging markets and multinationals need to call on new technologies and operating models to remain competitive.
- For insurers, the rise of services trade and intangible assets in business value presents new risk pool opportunities.

About Economic Insights
Analysis of key economic developments and their implications for the global re/insurance industry.

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In a nutshell

Trade has been a primary growth engine for emerging economies for a long time, but momentum on that front has slowed. We believe maturation of global manufacturing value chains is a main reason. Multinationals and global insurers need to adapt to this structural shift. The rise of services trade and digitisation, meanwhile, provides opportunity for insurers to cover new risks.

In absolute terms, emerging market merchandise trade continues to increase. However, trade intensity -- the percentage of output that is traded -- has remained stagnant since 2012 (see Figure 1). Slowing global economic growth and weaker commodity prices are part of the reason. At the same time, with rising protectionism, the pace whereby countries reach bilateral and regional trade liberalisation agreements has slowed. The impact has been compounded by rising number of tariff and non-tariff barriers such as quotas, bailouts, state aid and trade defence measures.[1] In addition, the shift in China's growth model from investment to consumption-led has reduced the nation's need for imports of capital goods and export of intermediate goods, as the bulk of final goods are now consumed in the domestic market.[2]

Above all, we believe a major contributing factor is the maturation of global supply chains. In the spirit of free trade, a fragmented production process across countries is a natural result of globalisation. But the participation of trade in the global value chains (GVC) appears to have reached saturation point post the global financial crisis. GVC, as measured by the foreign value added of gross exports,[3] peaked in 2011 and has since been on a declining trajectory. While firms are still keen to cheaper labour or natural resources, increasingly the offshoring of production brings other challenges such as lack skilled labour, distance from end consumers, and poor-quality infrastructure. The increasing share of services value embedded in operations and sales processes, such as product design, intellectual property and consulting are also leading to more onshore production of final goods.

To quantify the impact of GVC participation on emerging market trade growth, we follow the model by Borin and Mancini (2015) to estimate its contribution.[4] Figure 2 shows that between 1995 and 2004, emerging market trade grew at an average of 1.8 times of the growth of the underlying economy. The trade elasticity, defined as the ratio of growth rate in exports to

[1] *Global trade: What's behind the slowdown?*, IMF, October 2016.
[2] *The global trade slowdown and its implications for Emerging Asia*, Federal Reserve Bank of San Francisco, November 2016
[3] Data source is from OECD TiVA database, which computes the value added by each country in the production of goods and services that are consumed worldwide, based on the inter-country Input-Output tables. https://stats.oecd.org/Index.aspx?DataSetCode=TIVA_2018_C2#
[4] Borin, A. and Mancini, M., *Follow the value added: bilateral gross export accounting*, Banca d'Italia Economic Working Paper, 2015.

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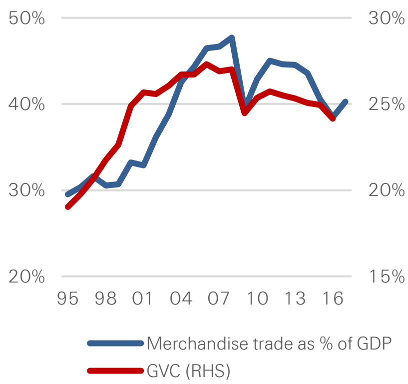
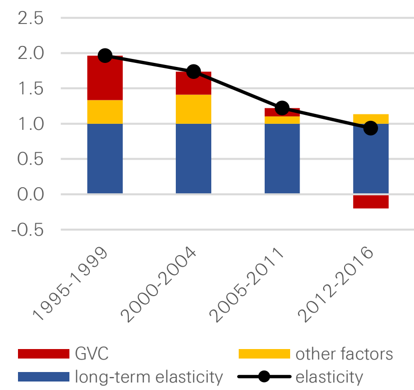
growth rate in overall GDP, levelled off after the financial crisis and averaged only 0.94 between 2012 and 2016. Assuming long-term elasticity between trade and GDP is unity, we conclude that GVC has played a decreasing role in supporting trade growth, and even a negative one after 2012.

Figure 1 (LHS)
Merchandise trade in emerging market

Figure 2 (RHS)
Contribution to emerging market income elasticity of trade



Source: WTO, OECD, World Bank



Source: Swiss Re Institute calculations

Our analysis yields even more pronounced results for Southeast Asia. The GVC factor contributed positively to trade growth before 2008, but dragged down trade elasticity by 0.35 after. Some market commentators currently say that ASEAN will stand to benefit from manufacturing relocation from China as a result of ongoing US-Sino trade tensions. We remain cautious: we are not convinced that the diversion effect will be anything more than limited, even for labour-intensive sectors.

According to a recent report, today only 18% of world goods trade is based on labour-cost arbitrage. [5] This "new normal" in emerging market trade slowdown has profound implications to global production and geopolitical relationships. Businesses need to remain alert of this structural shift and carve out new specifications in value chains by embracing next-generation technologies, such as automation and artificial intelligence, and by being in close proximity to end consumers. For global insurers, the uncertainty around trade presents some challenges to marine and trade credit lines of business. On the brighter side, however, the rise of services trade and increasing value of companies' intangible assets provide greater opportunities for insurers who can leverage developments in digital transformation to expand the scope of insurability to new risk pools.

[5] *Globalization in transition: The future of trade and value chains*, McKinsey Global Institute, January 2019.