

Trade Collapse and Policy Uncertainty in the Great Recession*

Jeronimo Carballo
University of Maryland
carballo@econ.umd.edu

Kyle Handley
University of Michigan
handleyk@umich.edu

Nuno Limão
University of Maryland, NBER
limao@econ.umd.edu

ABSTRACT

The 2008 crisis and economic downturn triggered the largest worldwide trade contraction since WWII. Standard models are unable to fully account for either the depth of this "great trade collapse" or its relatively fast reversal. The crisis also generated widespread fear of a global trade war. We examine if the resulting change in policy uncertainty initially deepened the collapse and then helped reverse it, when the worst fears of protection were not realized. To do so, we provide the first anatomy of the dynamics of U.S. exports at the firm level before, during and after the collapse. 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. We then develop a dynamic model with sunk costs of entry into foreign markets where heterogeneous firms face demand uncertainty arising from foreign policy and economic conditions. We construct measures of demand uncertainty that vary over time, countries and industries to estimate their impact on U.S. firms' export entry and exit decisions. Uncertainty had a significant impact on the magnitude of the collapse of U.S. exports and the subsequent uncertainty reduction contributed to the fast recovery. These effects were strongest for goods where the importer had higher market power and no free trade agreement with the U.S., which provides evidence for the role of institutions such as trade agreements in mitigating the impact of policy uncertainty.

* We thank the University of Maryland BSOS for financial support for part of this project. Any opinions and conclusions expressed herein are those of the authors and do not necessarily represent the views of the U.S. Census Bureau. All results have been reviewed to ensure that no confidential information is disclosed.