The Death of Distance is Greatly Exaggerated!

Barriers to global trade may be lower, but they still remain difficult to overcome for countries with less historical, legal or cultural ties and especially those far apart from each other. Experience can reduce costs and boost exports.

Every few years, a popular tome lands up on our desk, making heroic claims about a borderless world, a flattened world, and celebrating the inevitable irrelevance of distance. This is followed by frequent interviews on CNBC, weighty columns in the press, blog entries, tweets, and eventually TED talks. The author gradually moves into the hallowed ranks of gurudom.

Surprisingly, such claims of the death of distance are not a new phenomenon. Here is George Orwell from 1944: "Reading recently a batch of rather shallowly optimistic 'progressive' books, I was struck by the automatic way in which people go on repeating certain phrases which were fashionable before *1914* (italics ours). Two great favourites are 'the abolition of distance' and 'the disappearance of frontiers'."

Orwell could very well have been talking about Thomas Friedman's 2005 bestseller "The World Is Flat." Friedman adopted a somewhat loose method of justifying his thesis. These included jetting around the world talking to CEOs, playing golf, and astutely observing billboards. While the Friedmanesque method may seem compelling, we decided that a look at the data may prove more productive.

Unfortunately, the data tell a completely different story – distance matters almost as much for trade as it did nearly 40 years ago. In fact, distance matters shockingly as much for digital goods (that do not have to be shipped) as it does for physical goods (that do have to be shipped). Similarly, historical, legal and cultural ties, measured by colonial links in the past, sharing a common legal system, and sharing a common language are big facilitators of trade. Absence of such ties and physical distance seem to be a significant barrier to trade.

Expansion of world trade: More of the same?

At the same time, we have observed an explosion of world trade in recent decades. US$18.8 trillion worth of goods and US$4.6 trillion worth of services were traded across national borders last year, according to the World Trade Organisation (WTO). Barriers to trade continue to be lowered by free trade agreements that strip tariffs and other impediments to global commerce. Further growth in world trade of another 4.7 percent is expected this year.

But within this rosy picture about growing trade, there is another intriguing puzzle. We looked at IMF data, and found that from 1948 to 2006, less than 25 percent of the increase in world trade is attributed to the emergence of new trading partners. Despite wider liberalisation, free trade agreements and the formation of the World Trade Organisation, only a quarter of the increase can be attributed to countries forming new trading partnerships. 75 percent of the increase in world trade has actually come from countries that have traded with each other since 1948.

So we have two puzzles: Why is it that in an era of falling transport costs and lower trade barriers, distance, borders and assorted ties seem to matter so much for trade? And, why has the emergence of trade between new trading partners been such a small component of the last 6 decades expansion in global trade?

Experience in exporting matters

A project funded by U.K. Trade and Investment in 2005 surveyed firms in the U.K. and asked them what they considered to be the biggest barriers to exporting. Rather than transport costs and tariff barriers, firms mentioned that identifying contacts, understanding customers in the destination, coping with the regulatory and legal environment, and building networks and relationships were the key exporting barriers. When discussing barriers to trade, we usually think tariffs, market access, and transport costs rather than these barriers highlighted by exporters which to a large extent are harder to measure and are seldom the focus of negotiations in trade agreements. A free trade agreement or joining the WTO may reduce formal trade barriers but "unobserved" barriers remain, such as a lack of familiarity with regulations, customs procedures and distribution channels. The survey also showed that firms who had long experience in exporting to particular destinations claimed that these barriers are less important for them.

We built on this insight to look at the role of experience in international trade in our recent paper, **The Gravity of Experience**. International trade flows use something called gravity equation, an equation akin to Newton's law of universal gravitation. Newton's law, states that the attraction between two bodies is directly proportional to the size of the bodies and inversely proportionate to the distance between them. Replace size by GDP and measure distance as distance between largest cities, and we have an equation which does a phenomenal job in explaining trade flows. We adjust this gravity equation to account for the role of experience. Measuring experience based on historical trade between pairs of countries since 1870, we find that an extra year of experience between a particular exporter-importer country-pair lowers bilateral trade costs by 2 percent and increases bilateral exports by 8 percent. This is because the accumulation of experience over time helps to overcome the informational, contractual and cultural barriers involved in trade.

The importance of experience helps explain the wide gulf between trade flows among existing partners and new partners. Countries that have been trading with each other since 1948 have deep knowledge of the idiosyncratic and unmeasured barriers associated with each destination. The accumulated experience allows them to easily overcome such barriers. Countries lacking such long and deep experience in trade find such trade barriers far harder to surmount. In this light, the pattern of the expansion of trade seems less puzzling.

Building experience

There are two ways firms can accumulate experience: first, a firm benefits from its own interactions in the destination country and in the second instance, the experience of incumbent firms is shared with others. We find evidence for both. Experience helps incumbents, but also spills over across firms and products. As an exporting country accumulates experience, not only does the volume of good exported by incumbents expand, but we also observe entry of new goods and of new exporters.

In the beginning of a trading relationship, the volume of exports in existing categories traded goes up as companies get to know their destination counterparts. In fact, many first-movers should be willing to run at temporary losses to build experience in the destination market, with subsequent profits compensating them for initial losses. Over time, experience spills over non-exporters, and we observe a broader set of goods being traded. Non-exporters should therefore be proactive in learning from the experience of others.

Distance and other ties matters less with experience

Our results also hint why we see the persistence of distance in inhibiting trade even in the face of waves of globalisation. Distance between countries remains a hurdle to trade, but the effect is more nuanced. First, the good news. We find that experience from repeated interaction contributes to diminishing the inhibiting role of distance. This is not just true for geographic distance. If the two countries lack historical links or have very different legal systems, it is harder for them to trade. But the barriers attributable to these ties, or lack thereof, also diminish with experience. Therefore, with a continuous trading relationship, these barriers become less important over time. But when trade emerges between new pairs of countries, and this is usually between countries that are distant and lack historical and cultural ties, the distance barrier looms very large since they have little or zero experience in the destination country.

The only exception is language - if the two countries share the same language, they trade more and its effect is immune to accumulation of experience. In fact, the effect of experience is even stronger in the presence of linguistic ties. Not surprisingly, exporters have an easier time of navigating the new environment if they can speak the same language in the destination.

But how do you build this experience to boost trade with countries you might not already be trading with?

Giving exporters a boost

Given that the benefits of experience tend to be shared among firms and industries, there is scope for policy support. Export promotion agencies can help in this area, supporting the entry of early exporters, even temporarily, which may lower the trade costs and encourage entry by new firms and new product categories into export markets.

Japan and South Korea are good examples. Their export promotion models have historically identified "national champions" that are subsequently given subsidies to go out into export markets and build trading partnerships. Even if the subsidy is temporary, ties will be formed and for the most part persist, which means there are enormous advantages to temporary export subsidies.

At the same time, there is no universal case for export promotion. Our results show that experience counts the most when exporting to a distant destination, with countries that are non-contiguous, and with countries that have different legal systems and no shared colonial links. Promoting exports to neighbours and to familiar destinations with strong ties is not justified.

Firms can also be brought together to share their experiences on certain markets. Singapore's trade promotion body, IE Singapore, holds an array of conferences and gatherings to encourage knowledge sharing between its outward facing companies. Industry associations may help as well, where incumbents share experience of markets, customers, regulations.

Based on our findings, we should continue to see growth in trade between existing partners, but given that there are diminishing returns to experience, as new partners gain more experience dealing with one another and a little help from export promotion policies, we should increasingly see the growth in world trade happening among new pairs of countries.

Pushan Dutt *is an INSEAD Associate Professor of Economics and The Shell Fellow of Economic Transformation. He is also a director of the Asian International Executive Programme, part of INSEAD's executive education suite.*

Ana Maria Santacreu *is an INSEAD Assistant Professor of Economics and Political Science*.

Follow INSEAD Knowledge on Twitter and Facebook

Find article at
https://knowledge.insead.edu/economics-politics/the-death-of-distance-is-greatly-exaggerated-3348

Download the Knowledge app for free