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The Impact of Foreign Trade on the Economy

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Foreign trade has become more important to our economy in recent years. Exports and imports of goods and services have grown rapidly. A growing trade volume benefits our standard of living in several ways, but, as the recession deepens, my focus here will be limited to the impact of the trade balance on America's gross domestic product and, by implication, its job market. G.D.P and employment generally move in the same directions; so what I say about the impact on G.D.P generally applies to employment as well.

G.D.P., as I've discussed here before, is the way economists calculate how much an economy is producing in total goods and services. It is usually calculated by adding together several categories of spending, including consumer spending, investment and government spending. Exports of goods and services generate income at home, and so they are also a component of G.D.P. Imports, on the other hand, generate income abroad, so they are subtracted from the other categories of spending to get a more complete picture of how much an economy is actually producing. Higher exports and lower imports add to G.D.P., while reduced exports and higher imports contract G.D.P.

For many years we've had a deficit, in which imports exceed exports, but in recent quarters a decline in that deficit has contributed to G.D.P. growth. In 2007, exports were 12 percent and imports were 17 percent of G.D.P., compared to the third quarter's 13 and 16 percent.

In other words, because the gap between imports and exports has been shrinking, it has had a much smaller negative effect on G.D.P. — thereby allowing the economy to grow. The drag on G.D.P. becomes less as you move from a larger negative to a smaller negative. Think about facing a 50 mile-per-hour headwind that is reduced to 25 miles per hour; you're still facing a headwind, but you can move a little faster.

The shrinking trade deficit contributed 2.93 percentage points to G.D.P. growth in the second quarter, and 1.07 percentage points in the third quarter. (You might know that G.D.P. overall didn't grow nearly this much — in fact, in the second quarter G.D.P. grew at an annual rate of 2.88 percent, and in the third quarter it shrank 0.5 percent. This is because other forces — in particular the decline in consumer spending — offset gains in trade.)

Why has the trade deficit been shrinking? Because changes in the value of the dollar relative to other currencies have made our products look relatively cheap.

American exports respond positively to higher foreign demand and a cheaper dollar. Our imports grow with higher domestic demand and a more expensive dollar. The decline in our trade deficit in recent years resulted primarily from the depreciation of the dollar, since most countries were growing simultaneously with the U.S. and thus partially neutralized the influence of differential growth rates. Dollar depreciation made our exports cheaper to foreigners and our imports more expensive to us.

However, in recent months, as the financial crisis has worsened and spread abroad, the dollar has rebounded, presumably the result of a "flight to quality." Apparently, when the chips are down, the dollar is still considered the safest currency in the world despite the crisis having originated here. "Flight to quality" is usually applied to a move from riskier investments into riskless (from a credit standpoint) Treasury bills.

If the dollar continues to appreciate rapidly, our trade balance will change from a positive to a negative impact on G.D.P. Growth in exports and the decline in imports showed smaller changes from the second to the third quarter, as you'll see in the table below. This may mark the beginning of that transition.

If our trade deficit increases at a time when consumer spending is falling and investment is flat, fiscal policy will be the only game in town. Hopefully, dollar appreciation will slow enough for net exports to continue growing and supporting our economy — and our jobs.

	2008 Q-II	Q-III
Change in real GDP	+2.8%	-0.5%

Growth of Exports and Imports of Goods and Services

Change in exports	+ 12.3%	+ 3.4% (positive for GDP growth)
Change in imports	- 7.3%	-3,2% (positive for GDP growth)

Contributions to Percent Change in Real GDP

Change in exports	+ 1.54	+ 0.46
Change in imports	+ 1.39	+ 0.61
Total trade impact on Real GDP	+ 2.93	+ 1.07

Source: Bureau of Economic Analysis
Department of Commerce

Source: Bob McTeer