

Improvement US trade deficit to end as the economy recovers

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- US exports and imports of goods and services both plunged in real terms in Q1 2009, but imports dropped by more. The resulting improvement in real net exports actually made a big positive contribution to real GDP.
- However, forces are at work that will tend to end the improvement in real net exports. They include the moderate recovery in US domestic demand, relatively weaker economic growth for major trading partners in Europe, Japan, and parts of Latin America; and the appreciation in the weighted average value of the dollar since April 2008.
- Moreover, the visit this week of Treasury Secretary Tim Geithner to China drew renewed attention to the gaping bilateral deficit that the US now runs with that country. The key issue of the long-term relationship between the US dollar and the Chinese renminbi was touched upon only in the gentlest diplomatic language. And China did not pledge to bring down its sizable trade surplus.
- But concerns over the size and composition of the US trade deficit will not stay subdued indefinitely. The US Congress will eventually call for more active efforts by the Obama administration to promote US exports, even if it means pushing for a depreciation of the dollar in the foreign exchange markets – a policy course fraught with danger for the financing of the existing deficit and thus for US interest rates.

Recessions usually lower the US trade deficit but not always

The US runs trade deficits almost every year these days but that has not always been true. Whether or not the US has a trade deficit or surplus at a business cycle peak, the trade position normally improves during recessions. Since the collapse of the Bretton Woods fixed-exchange rate system in the early 1970s, the US trade position worsened in only one recession, the deep global economic downturn of 1981-82. That was a case in which US exports fell more sharply than imports. Otherwise, Imports decline to a greater extent than exports, as domestic spending contracts.

Trade position changes during major recessions

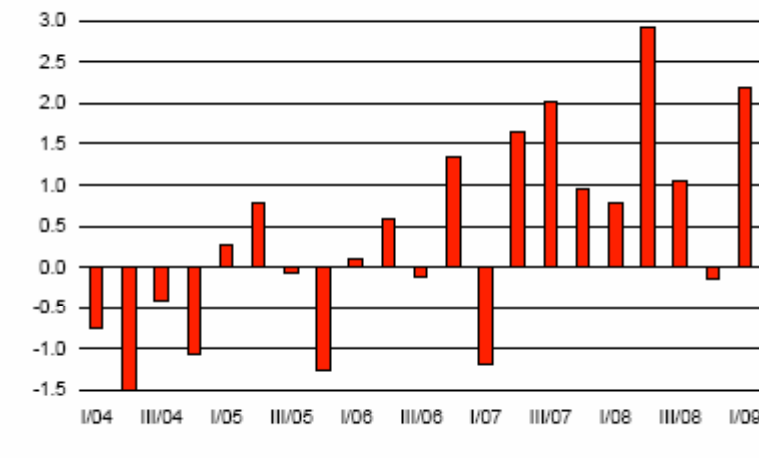
<i>Trade balance in USD bn, annual rates</i>	cyclical peak	recession trough (except Q1 2009 for current)
Nov 1973-Mar 1975	6.5	13.5
Jul 1981-Nov 1982	-11.1	-34.2
Jul 1990-Mar 1991	-77.7	-25.4
Mar 2001-Nov 2001	-391.1	-352.1
Dec 2007-present	-695.1	-359.6

Source: US Census Bureau

The improvement in the nominal trade deficit since the beginning of the current recession in December 2007 is the largest in dollar magnitude. It is also the biggest as a proportion of peak GDP. The improvement comes to 2.4% of GDP over the five quarters Q4 2007 through Q1 2009. When exports and imports of goods and services are adjusted for price changes, the improvement in real net exports has contributed an average of 1.3 percentage points to GDP growth over the period -- an annualized 2.18 percentage points in just the first quarter of 2009 alone. In other words, without the positive contribution from the reduction in the real trade deficit, the recession would have been significantly worse. The chart below shows the contributions of changes in real net exports for the decade of the 2000s:

NET EXPORTS SUPPORT GROWTH DURING RECESSION

Contribution of net exports to annualized GDP in pp



Source: Bureau of Economic Analysis

Unfortunately, it is highly unlikely the positive contribution can continue. Even though we foresee only a moderate (or "U-shaped") recovery, domestic demand will revive enough to boost imports again. The following table shows our current forecasts of the contribution of real net exports to real GDP growth over the coming year and a half. Real net exports will probably produce a negative contribution throughout the rest of this year and next.

Contribution of net exports to real GDP

<i>In percentage points, seas. adu.annual rates</i>	2009 Q1-a	2009 Q2-4-f	2010-f
Real exports	-3.86	-0.16	-0.30
Real imports	6.05	-0.27	0.10
Real net exports	2.18	-0.43	-0.40

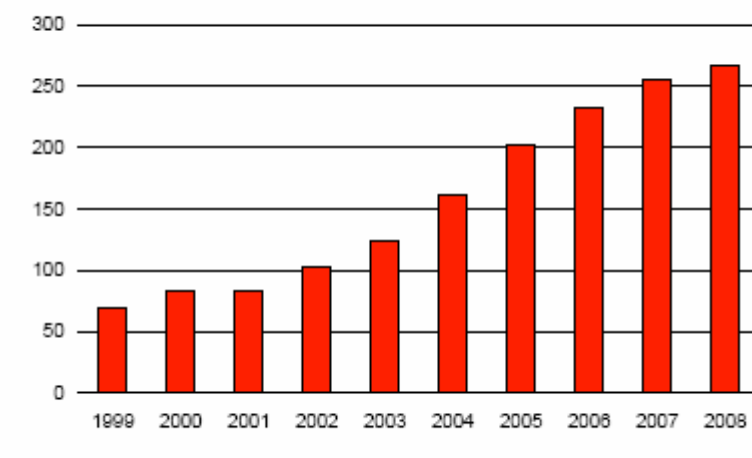
Source: US Commerce Dept., Census Bureau,

The US-China trade connection: record imbalance with no adjustment in sight

The facts are not pretty. China ran a trade surplus with the rest of the world of USD 295.5 bn in 2008, according to Chinese government figures. According to US government figures, the US bilateral deficit with China came to USD 266 bn last year, almost all of the Chinese global trade surplus. That means that the US bilateral deficit represents the largest trade imbalance in the world at the present time. The chart below shows how that deficit has climbed in recent years from modest to extraordinary magnitudes.

RECORD IMBALANCE

US trade deficit with China in USD bn



Source: Census Bureau

What is perhaps equally worrisome is the extreme skewness of the US-Chinese trade imbalance. The ratio of US imports of Chinese goods to US exports to China is greater than any single bilateral imbalance with a major trading partner. In 2008, that ratio was 4.72. In other words, Chinese exports to the US (USD 337.8 bn) were almost five times Chinese imports from the US (USD 71.5 bn). By comparison, the table below shows the export to import ratio for the five largest bilateral deficits. Even oil exporter Saudi Arabia, the next most unbalanced trade relationship with the US, had a lower export-import ratio.

US trade imbalances with countries with largest bilateral deficits

USD bn	2008 deficit, USD bn	Export-import ratio
China	266.3	4.72
Canada	74.6	1.28
Japan	72.7	2.09
Mexico	64.4	1.42
Germany	42.8	1.78
Saudi Arabia	42.3	4.38

Source: US Commerce Dept., Census Bureau, UniCredit Research

Congressional pressure for Chinese action is low key now, but percolating

The political problem posed by huge, persisting bilateral US trade deficits with China is straightforward. When the US economy is growing rapidly, enormous US imports from China provide an important function. They improve US living standards and serve as a buffer against inflation. By contrast, in a prolonged recession, the disinflationary benefits are valued less highly, while the fact that China may be taking market share away from other emerging market suppliers, especially Mexico, is seen by many members of US Congress as unfair. What they would like to see is an explicit Chinese government commitment to adjust the country's overall trade surplus, which would almost certainly involve a meaningful reduction in the size of the Chinese trade surplus with the US. The Chinese economic stimulus program was well-received, because it is viewed as likely to produce a visible increase in imports.

But members of Congress believe that a sizable appreciation of the Chinese currency should also be undertaken as a further tool for adjusting the trade surplus. This policy position has considerable bipartisan support and legislation to introduce a substantial tax on Chinese imports would clearly pass if it were submitted. The Bush administration threatened to veto such a bill, but in return promised to successfully negotiate a trade and exchange rate agreement with China.

That never happened. Treasury Secretary Geithner's visit to China this week did not produce such an agreement, either. To the contrary, there are no public reports that even informal negotiations were held.

If the US recession ends soon and a recovery begins later this year, some of the Congressional pressure may wane -- but not if the recovery generates a renewed upsurge in imports from China and a larger bilateral US deficit. The US Treasury itself is caught in a dilemma: it needs Chinese financing of a large and growing US budget deficit and thus has to maintain cordial relations, even if that means accepting an even bigger trade deficit. But unless US economic conditions improve sufficiently fast, Congressional efforts to pass a veto-proof bill may become unstoppable. Bond market participants will follow this ongoing debate with great intensity, since it may be one of the most important determinants of movements in yields on US government securities in the year ahead.

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