The Economy and the Trade Deficit

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The latest statistics on first quarter economic growth reflected a decline in the gross domestic product (GDP) of 1.4%. This report was a surprise for most economists as the expectation was for a gain of 1.5% - 2%. The result was heavily influenced by the size of the trade deficit, the difference between imports and exports where the demand for imported goods in an expanding economy was much greater than the world's demand for U.S. products where Covid is still having a residual effect. The net exports number for the period was -3.2% easily changing a positive to a negative quarter. The bean counters subtract that deficit from economic activity that results in a minus GDP number. But let's take a look at what that trade deficit means. Foreigners benefit from the fact that Americans are willing to buy their goods and services. They get paid in dollars, the global reserve currency that has been rising in value vs. other currencies. So Americans get real goods and services and foreigners get paper money in exchange. To the extent that foreigners are willing to accept dollars, it is because they believe that they will be able to buy U.S. goods and services at some future time and, in effect, offset the trade deficit. If that does not happen, then the U.S. benefits from that trade deficit as it becomes the beneficiary of foreign imports that are never exchanged for U.S. exports. For example, if the Japanese sell a Toyota in the U.S. and the company holds that cash it received in payment for the car, then the U.S. customer enjoys the use of the car while the Japanese hold a bank account with money that may or may not be spent. How does that exchange lower economic growth in the U.S.?

Even in the face of a prolonged war in Ukraine, a tight Federal Reserve monetary policy that is pushing interest rates higher and a plunging stock market, foreigners are buying up U.S. dollars! The dollar has been hitting new highs as foreigners are seeking a safe haven against the possibility of further Covid disruptions in world trade, global inflation and the war in the Ukraine.

Another implication of a strong dollar is that the price of imports will be falling as Americans can use dollars to purchase foreign goods at lower prices. This transaction means that the trade deficit will get larger not smaller in coming months as long as Americans continue to spend that money received from the government during the Covid crisis. Hopefully the savings on imports due to the strong dollar will be used for increased domestic consumption that will add to the GDP calculation in future months.

If inflation continues to stay at current levels or go higher, the prices of our exports will increase. For foreigners, this is a double-whammy – with rises in both inflation and dollar prices. Multinational companies that depend on foreign earnings may be in for a surprise when these factors force a downward adjustment in their profits. Foreign exporters to the U.S. will benefit from higher U.S. inflation as they will have a competitive advantage if their inflation rate is lower. However, they still will have to overcome an unfavorable currency translation when competing with U.S. companies.

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