Gdp growth and trade deficits relationship

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Gross Domestic Product is a measure of the value of output produced within an economy over a 12 month period. Nominal GDP is output valued at current prices. Real GDP is measure of output in real terms that is after taking into account inflation.

There are three ways of GDP, each will give the same value of output and hence the same GDP

The expenditure method takes into account the values of all spending on goods and services in an economy. The output method records the value of goods and services produced by firms and bought by households. The third method is the income method records the value of all incomes earned by households and firms over a fiscal year.

Measuring GDP by any of the three methods has several drawbacks. GDP for instance is measured at current prices and this includes VAT or taxes on spending. Taxes are not part of output and GDP is inflated because of this. Gross Value Added (GDA) is the alternative to GDP since it excludes taxes on spending from output.

Since countries operate in a globalised world their economies are open to external impacts. Countries trade with other countries, selling goods to others (exporting) or buying from them (importing). Countries have to hence maintain a record of all international transactions. This is kept through the balance of payments and balance of trade, the latter being a component of the first one. Balance of payments is a record of all inflows and outflows that an economy experiences over a year. Balance of trade is inflows and outflows generated form trade in goods and services only. It does not include

remittances, interests, profits and dividends on investments which are part of the balance of payments.

Balance of trade deficit or simply trade deficit represents a larger inflow of foreign goods (in value) compared to exports over the corresponding period. The shortfall or deficit has to be financed out of international borrowings or from surpluses on balance of payments or from surpluses from previous years. Surplus on the balance of trade account reflects excess of exports over imports. Any retained surpluses can be used for paying back loans or to match off deficits on other components of the balance of payments account.

Countries do not consume all of the output they produce as well as do not only consume only what they produce and account of this has to be taken when measuring GDP. GDP as we discovered could be measured through any of the three, expenditure income or output method. But all three methods will give a value which will include an element of international trade which needs to be accounted before a true and representative picture of GDP can be drawn. Expenditure on goods for instance includes spending on foreign goods which is not the economy’s output. Output method may include for instance raw materials imported by producers which again should not be part of economy’s output. The income method like the other methods also includes element of cross border trade say income generated from sale of imports by retailers for instance which is and should not be part of country’s GDP. Because GDP would include output that is not produced from within the economy account of this is taken by making amendments when measuring GDP. A common and ideally simple means of calculating GDP is as follows

National Income= National Output= National Expenditure= GDP= C+I+G+X

Where

C= Consumer Expenditure

I= Investment (Capital produced -Capital Consumed)

G= Government expenditure

X= Net Exports (Exports-Imports)

Economic growth is a desirable economic phenomenon as it increases welfare and improves standards of living. Economic growth is the increase in potential output of the economy and is shown by a rightward shift in the Production Possibility Frontier. GDP growth refers to the actual increase in output over a period.

CAPITAL GOODSCONSUMER GOODS

ECONOMIC GROWTH

0

GDP growth increases output people can enjoy. It raises standards of living as well as disposable incomes. Consumer Expenditure is high since more is produced and sold. As a result people enjoy better incomes and have money to spend on foreign goods. If domestic production is insufficient and or does not provide variety that consumers want, consumers will switch to buying foreign goods with their excess disposable income. This is that the propensity to import increases. The growth in GDP has hence led to growth in imports. Exports are also likely to fall because domestic demand is high. Trade is likely to tilt unfavorably against the economy and it may experience

deficits. This is just one simple case of relation between GDP growth and balance of trade account.

Growth in GDP or output could be due to various reasons. GDP growth for instance may be a result of import led growth or export based growth. The stage of business cycle in the domestic economy as well as the health of the global economy is also an important determinant of growth as well as trading patterns both of which also are closely related

Theory 1- Trade deficit kills growth!

Countries where growth is export-led such as those of raw materials, oil etc are likely to experience trade surpluses during periods of world economic expansion. Saudi Arabia for instance is a country that has export led growth, that through oil. Its trade balances are mostly favorable. The surpluses generated from exports can be pumped back into the domestic economy (by spending less on fulfilling international obligations). If the excess money succeeds in increasing productive potential of economy GDP may improve. However if the surplus fails to raise domestic production in response to higher demand it will only create inflationary pressure on the economy. Export led growth may fall in times of world recessions, where international demand weakens. However if good exported are have low elasticity of income and price such as they are essential drugs and fuels trade will still prosper.

Countries with trade and balance of payment deficits are also likely to have weak currencies. If government practices free and floating exchange rate any trade deficits will result in the currency being depreciated (loss in value

of currency in terms of other currencies). This is because supply of the economy's currency is high since it demands more international goods than it sells in the international market. This fall in currency value might make it useless for some foreigners who may decide to dump the currency on international market. This dumping may further increase supply of currency and cause it to loose value. This extensive depreciation can cause extensive damage to GDP of an economy. If the economy is also an importer of raw materials its ability to import may be strained given the same currency. Its ability to produce may be further limited and its GDP growth might take a downturn.

Theory 2-Trade deficits promote GDP growth

The other close relationship between trade deficits and GDP strength is surprisingly positively correlated. In some cases trade deficits can actually be a boost to GDP growth. Increasing trade deficits could in fact lead to GDP growth. When an economy experiences trade deficits, demand for its goods is less than its demand for goods. Likewise the demand for its currency is lower than its demand for other currencies.

PRICE OF CURRENCY IN TERMS OF BASKET OF OTHER CURRNCIES

P0

Quantity of currency traded

Q0

As exports fall and imports rise supply of currency to international market will grow while its demand will contract (Figure A).

OLD DEMAND AND SUPPLY CURVE

NEW DEMAND AND SUPPLY CURVEFIGURE A KEY

PRICE OF CURRENCY IN TERMS OF BASKET OF OTHER CURRNCIES

Quantity of currency traded

P1

Q1

P0

Q0

In a free floating exchange rate system any trade deficit will automatically lead to depreciation of country's currency. This fall in value of exchange rate makes exports look cheaper and more competitive. As elasticity of exports is higher in the long run (buyers have time to shift orders to lower cost economies, however current and short term pledges and orders are difficult to withdraw) buyers will react by demanding more. Output will have to be increased to service these extra orders and hence GDP will grow. Trade deficit will start to narrow but the actual change in trade imbalance will depend not only exporting pattern change but also on whether output produced requires imports (raw materials and machinery etc.) The fall in trade deficit is likely to be smaller in this case.

According to theory 1 economy would begin to crumble under trade deficits. It is also logical too. If economies buy more than they sell economic activity will be hurt. Not enough jobs will be created as lost because of importing goods. This theory makes sense but numbers do not support it. Figures

especially from the American economy say otherwise. The US Census Bureau classifies the US economy as one on general growth pattern (improving GDP year on year) despite trade deficits also increasing. However there have been years when the GDP has not grown and in some cases has shrunk with increasing trade deficits. However rising trade deficits as well as growing GDP seems to be the nature of the American economy.

When statistics from the American economy are scrutinized Theory 2 seems to be more realistic and true. It is evident from the numbers that the American economy, the largest in the world, experiences a positive correlation between GDP and trade deficit. Analysts point the consumption nature of US economy responsible for this. This may be true for all other high consumption economies that would also experience a positive relation between growth and unfavorable trade balances. Such economies like the American one have high consumption expenditure coupled with low or even negative savings rate. Such developed economies are also noted to operate in the tertiary sector, being more service oriented. Demand for consumption is hence satisfied by production outside the economy and trade imbalances are inevitable in these economies.

Free Trade, cost effectiveness and growth

Allowing free trade to prosper that is trade without barriers and protectionism is an important step towards improving world economic prospects. Free trade allows goods to be traded at their fair values, that is in terms of their relative cost (opportunity cost), rather than artificial and tax inflated prices. This liberalization of international trade allows trading patterns to shift, from higher cost economies to lower cost economies which

originally seemed uncompetitive because of artificially manipulated prices. This liberalization breeds competitiveness’ and cost effectiveness. Countries with higher cost structures will loose out to competitive economies in free trade. This shift is likely to cause unfavorable trade balances for the competitive economies as exports move away to more effective suppliers. Imports of that good are likely to increase because it is cheaper to buy than to produce locally and this will further strain the balance of trade.

This restructuring of international trade is based on competitive advantages of countries; this is advantage in terms of lower opportunity costs of production. As world trade shifts and set s according to competitive advantage economies are likely to experience initial imbalances in their trade accounts. However international trade based on competitive advantage allows for elimination of wastage of resources and puts them into more productive use. Producing and trading based on comparative advantage allows for economies to specialize. This specialization will increase and improve output quantitatively as well as qualitatively and hence output and GDP will grow. In fact if all trade is allowed to adjust according to comparative advantage world GDP as a whole will grow and people will enjoy better standards of living in general. Since world output enhances it is only logical to assume that output from each economy also increases. People in each economy will therefore benefit from consumption of more output because of this productive efficiency.

TRADE DEFCIT DUE TO CAPITAL INVESTMENT

FIGURE 2. 2

FIGURE 2. 1

Consumer Goods

Capital goodsOne of the core problems facing all economies is that of scarcity. Economies do not have sufficient resources to produce and consume all they want. Countries have to forgo some part of their consumption to satisfy their other wants. This is a critical situation especially to developing economies like Pakistan where scarcity limits growth. Production of capital goods for instance has to be limited to meet consumer demands and produce consumer goods. The opportunity cost of this decision is long term growth prospects that the economy could have achieved by using the capital goods rather than producing to consume now (consumer goods)!

Good K

X

Y A

Good L

A

x B

A movement of output level in an economy from A to B for satisfying more consumer expenditure (XB) means the economy will have to forego AX of capital goods(Figure 2. 1) . This can strain future GDP growth as county's capital stock depletes or is insufficient to accommodate for increases in output.

Trade allows countries to consume outside their production possibility curve. For example by producing good K (Figure 2. 2) which is more expensive in thee international market, economy can specialize. By selling excess of its output in international market, output X-Y countries can buy other the good. Now the country can consume on point Y which was not originally available to it on the PPC curve. International trade hence enables countries to have better standard of living.

Countries that produce for satisfying current consumption or those who do not have the ability to produce capital goods may be dispensing with future growth in output through increased production capacity. These countries especially the developing ones are hence net importers of capital goods rest apart consumer goods. This import of capital goods puts strains on already limited trade surpluses the country may have. Developing countries that currently have low GDP and output and hence these countries export little and instead import more. If the larger part of the trade deficit is a result of a higher proportion of capital goods the economy may in the longer term experience GDP growth (given that its capital formation is greater than its capital depreciation). The increase in GDP and trade deficit in this case does not have a short run relationship. Trade deficits in this case can bring growth in near future. According to George Alessandria, economist in the research Department of the Philadelphia Fed, trade deficit is a sign of good things to come. Countries, he believe tend to have large deficits when they borrow to finance investments. Trade deficits are colligated with continued and strong economic growth over the business cycle (George).

In times of economic expansion, as output grows, both consumption and investment grow too. Investment is more fickly than output is and it often grows faster than output. The increase in output logically calls for trade deficits to narrow or turn into surpluses. However trends of economies in expansion show a different picture. Actually some of the extra output is not consumed but invested. But times of economic expansion are usually known for heavy investment and hence much of the resources for investment come from outside the economy. This trade deficit is a means of increasing future GDP without cutting down on current consumption.

HOW TO DEAL WITH TRADE DEFICITS

Trade deficits are not at all be as bad a problem as some people think. In fact controlled trade deficits are a sign of a good economy. However long and sustained trade deficits can be a sign of economy's ill health and may hamper the economy especially if bulk of the financing requirement for the deficit is met by international borrowing as well as that trade deficits also harm the balance of payments severely. Governments hence need to ensure that trade deficits are manageable and prolonged deficits should be dealt with.

There are two ways in which the government can improve its balance of trade situation. The first one is the expenditure switching approach. The government in this case will try to persuade both foreign and local buyers to consume more of local goods and less of goods produced outside the economy. These policies are not designed to reduce spending on goods but to switch the pattern of spending from foreign goods to domestically

produced goods. This if successful is likely to lead to a fall in import expenditure and a hike in export earnings.

The other approach that governments can take when dealing with trade imbalances is the expenditure reducing approach. The government using this approach tries to eliminate some part of the aggregate demand. This will have two principal effects. Firstly locals will buy and consume less and so imports are likely to fall. The second is that as producers find demand in home market weakening they will try and break into foreign markets. This deflationary effect is likely to cut back imports and improve export potential.