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The View From The Front of The Train

Some unique thoughts on how the U.S. economy affects the world—and vice versa.

BY ROBERT MCTEER AND WILLIAM GRUBEN

Even though U.S. output and productivity have picked up over the last year, softness in our labor market has motivated questions about economic events abroad triggering a turnaround here. Will bursts of expansion from our principal trading partners give us a push? The chances look slim. One way or another, this is something we'll have to do on our own.

Although the interconnections that make up the world economy are well known, some paradoxical details about the United States seem not to be fully appreciated. Much recent economic literature suggests that the more countries trade, the more alike their business cycles become. An upswing that starts in one country will follow in its trading partners. Figure 1 shows how indexes of trade as a percentage of GDP have grown for each of nine countries since 1965. Because these are indexes, they do not show trade's actual share of GDP; they only show how much the share has changed from the 1965 index value of 100.

Most of the countries in Figure 1 have seen very large expansions in their trade/GDP indexes, signaling increased links between their business cycles and those of other countries. Japan's trade share has not changed much at all, and Singapore's has only grown a little (trade has always been important in Singapore). But between 1965 and 2001 the other seven countries raised their trade/GDP shares by at least 50 percent (that is what the 150 means on the vertical axis). Mexico and South Korea increased their trade share indexes by more than 200 percent.

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While U.S. trade as a percentage of GDP did not grow as rapidly as Mexico's and South Korea's, it still increased by about 150 percent between 1965 and 2001. Of course, U.S. GDP itself has expanded a great deal over this period. The 150 percent growth in the trade/GDP ratio just means our trade jumped even more. No wonder other countries' business cycles move with ours.

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Changes in the composition of trade accent its role in harmonizing business cycles. Steadily and persistently, manufacturing and services have become more important components of overall trade during the last several decades. This transformation has occurred not only among our European trading partners and in Asia, but in Latin America, sub-Saharan Africa, and the rest of the developing world. Much more than primary products, fluctuations in these same industrial and service activities are the basis for business cycle correlations across countries. The increased role of these activities in trade sharpens the sensitivity of one nation's cycles to another's.

But among these trends, a trade paradox complicates one of the United States' roles in the transmission of business cycles. Despite the large increase in U.S. trade's share of GDP, the United States still does not trade very much relative to total output. In thinking about how other economies may affect ours, this detail deserves attention. Of the 171 nations for which the World Bank collects data on trade, just five post less as a share of GDP than the United States' 24 percent. We do trade more than the Sudan (23 percent of GDP), Brazil (22 percent), Argentina (21 percent), Japan (18 percent), and Myanmar (1 percent). But we are far below even middle-of-the-road trading countries such as France (50 percent) and Germany (58 percent), to say nothing of Ireland (161 percent) and Singapore (313 percent).

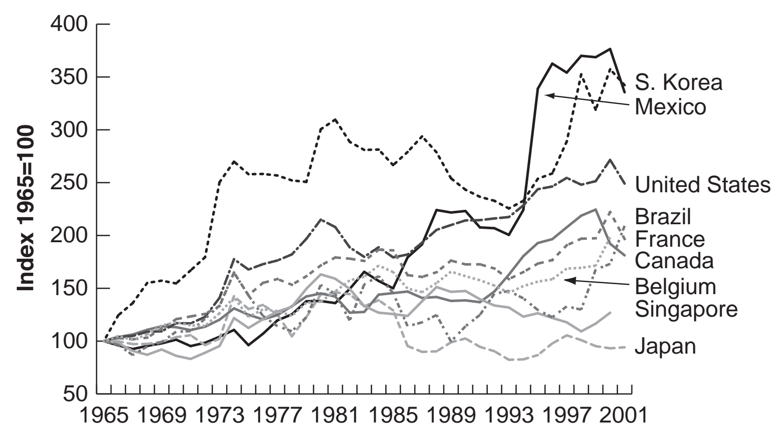
Sometimes, however, ratios mask important realities. Even though U.S. trade as a share of GDP is small compared with other countries', it still constitutes nearly one- fourth of our $10 trillion economy. While this means trade turns out to be pretty important to us after all, it is much more important to some of our trading partners. Despite a trade-to-GDP ratio of only 24 percent, the dollar value of our trade is not only greater than any other country's trade, but also larger than any other country's GDP except Japan's.

The paradox of having nearly the lowest trade-to-GDP ratio of any country but also the highest level of trade of any country offers pointed implications for the relation of our business cycle to those of other nations. It suggests that while trade and other international events obviously affect the United States, the United States is likely to affect other countries' business cycles far more.

The role of monetary shocks in the international communication of business cycles complicates these issues still more and re-emphasizes the impact of U.S. cycles on other countries. There is much evidence of a jump in international business-cycle correlation since the replacement of the Bretton Woods fixed exchange rate arrangement with a more flexible system.

Related post-Bretton Woods increases in the volatility of U.S. monetary shocks compared with those of other large economies—and the transmission of these shocks—have pushed up the correlation of many na-

Figure 1
Across the World, Trade Increases as a Share of GDP



Source: World Bank, *World Development Indicators.*

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tions' output with the United States'. Even without changing trade patterns, monetary events in the United States may drive business cycles elsewhere more than they used to—but not so much the other way around.

If the United States were as susceptible to foreign business cycles as some other countries, the slow economic progress of most of our trading partners lately means that they have been able to rely on us for more growth than we got from them. As of this writing, GDP growth data for the fourth quarter of 2002 over the fourth quarter of 2001 are not in for all of our trading partners, but we know that most of the top twenty grew slower than the United States—and the top twenty accounts for more than four-fifths of U.S. trade.

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It is clear that plenty of other foreign events are affecting the U.S. economy and will in the future. The terms of trade shocks that have lately swept through the industrial economies as a result not only of conflict in the Middle East but also of events closer to home in Venezuela may have a protracted aftermath—especially if remnants of the Venezuelan petroleum outages that began last December continue.

Other factors are more difficult to assess, but will clearly have much meaning for us in the future. Not many Americans noted that last year was the first in which the combined exports of the People's Republic of China and Hong Kong to the United States exceeded those of Japan. Over the last twenty years, moreover, the ratio of China's GDP to Japan's has quadrupled in dollar terms.

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But while these are important phenomena, it is possible to make too much of them. Despite the rapid growth of China and the Asian tigers, the combined dollar-denominated gross national product of China, India, South Korea, Taiwan, Thailand, Malaysia, and the Philippines is still less than two-thirds of Japan's.

In sum, changing patterns of trade and of exchange rate and monetary policy have converged to harmonize business cycles across the world, but the United States seems to affect other countries' business cycles more than they affect ours. Even so, terms of trade and international supply shocks can have both rewarding and punishing effects on the U.S. economy, and for now some of the most obvious don't look like rewards. Behind all of this, longer-term transformations in foreign economies—and perhaps most of all in China—are turning their relations with the United States and its trading partners in directions we can understand, but only partially. ◆