July 1, 2015

Far Away Yet Close to Home: Discussing the Global Economy's Effects

In case you needed any motivation to take interest in the outcome of ongoing negotiations between the Greek government and its international creditors, this excerpt from the *Wall Street Journal* ought to do it:

> Global growth is really important. We are all connected through the financial markets, through foreign-exchange markets," Fed governor Jerome Powell said last week in an interview with The Wall Street Journal. "If global growth weakens, or remains weak, and we get into a trend of that, then yes, that will be a big headwind for the United States economy."

Last week, I participated in the latest edition of our webcast, *ECONversations*, devoted to the theme "what to make of the first quarter?" (The webcast can be found here). The conversation revolved around the Atlanta Fed staff's view of why 2015 began with such a whimper and ideas on prospects for improvement through the balance of the year.

Not surprisingly, the international context loomed large. Between June 2014 and March 2015, the U.S. dollar appreciated by about 14 percent against a broad basket of currencies, and by about 20 percent against major currencies. The dollar has roughly remained in those neighborhoods since. As to the gross domestic product (GDP) side of the story, arithmetically net exports subtracted almost 2 percentage points off first quarter growth.

A key assumption of our current outlook is that the international environment (including the exchange rate) will stabilize, and smoother sailing without the "big headwind" referenced by Governor Powell is ahead.

That assumption generated some discussion (in the Q&A part of the webcast, and via online questions). With some paraphrasing, here are a few of the comments and questions we received, and my best attempt to respond:

Q: *You associate the prior appreciation in the dollar with a several percentage point subtraction from growth in the first quarter. This seems quite large in context of available research on the elasticity of the trade balance to movements in the foreign exchange value of the dollar*.

A: In the webcast, I did loosely refer to the trade effect on first quarter GDP as a "dollar effect." But the questioner—Barclay's head of U.S. economics research, Michael Gapen— is completely correct in asserting that standard estimates wouldn't support exchange-rate appreciation as an all-encompassing explanation for the big first quarter trade deficit. Our own estimates imply that four quarters after an exchange rate shock that raises the real broad-dollar index by 10 percentage points, real GDP is about one-half a percentage point lower than it would have been without the shock. This impact is roughly the same as most standard estimates (including Barclay's).

Some analyses might imply a larger GDP impact for the pure dollar effect, but any reasonable estimate would leave a fair amount of the first quarter net export decline unexplained. In any event, exchange-rate movements are both cause and effect, which brings us to:

Q: *I have a question regarding the impact of the U.S. dollar (USD) in the economy. We often learn that changes in the real exchange rate affect the economy with a lag. Take Japan, for instance. It had a substantial depreciation in Japanese yen (JPY) real exchange rate but with very minimal impact on Japan's trade performance so far. What makes you so confident that the strong USD has had a strong impact in the U.S. economy in such a short period of time? Wouldn't the negative contribution from net exports more likely be linked to delays in West Coast ports and the sharp slowdown in Asian economies (China, in particular)?*

A: Yes, in our analysis (and most we know of), the effects of exchange rates occur with a lag. And, as noted above, only a fraction of the decline in net exports by the end of 2014 and into the beginning of this year can be plausibly attributed to dollar appreciation. But we do think those effects are there, and they are continuing (to a lesser extent) in the current quarter.

Of course, changes in the value of the currency are an effect of other developments as well as a cause of changes in exports, GDP, and the like. All else is not typically equal, which often makes simple correlations (or, in the Japanese case, the lack thereof) difficult to interpret.

One of those "not equal" things could well have been the port delays. We don't have a firm estimate of how the backlogs might have affected the first quarter GDP statistic. If the impact was indeed material, we should see some reversal in the second and third quarters now that things are apparently getting back to normal. We'll count that as an upside risk.

And looking forward?

Q: *Shouldn't the economic crisis in Greece dampen the demand for American exports and decrease growth well into the fourth quarter?*

A: The good news is that current forecasts suggest 2015 euro-area growth will exceed its 2014 pace (according to the World Bank). In fact, the 2015 forecast strengthened over the course of this year despite the ongoing uncertainty associated with the Greek crisis. By most accounts, Canadian economic activity this year is expected to follow a trajectory similar to the United States (in like a lamb, out like something less lambish).

Mexico, as well, is expected to show more growth this year than last, despite some softening of the outlook since the beginning of the year. Put those three together (expanding the euro area to the entire European Union), and you have the anticipation of some improvement in countries accounting for somewhere in the neighborhood of 55 percent of our export markets.

The bad news is the ongoing uncertainty associated with the Greek crisis. Further, the outlook in emerging economies is growing more downbeat. These realities—a continuing impact of prior dollar appreciation and the fact that *better* foreign growth still does not equate to *great* growth—has us reluctant to think that net exports will be a big positive number in this year's GDP calculations. That reluctance notwithstanding, for now we are writing in a smaller trade deficit over the course of the year than what we saw in the first quarter.

If you want to go into the July 4 holiday on a somewhat optimistic note, I'll note that our GDPNow estimates for the second quarter have strengthened substantially with the arrival of more recent data—notably including signals of a much lower trade deficit effect than in the first quarter and today's positive news on manufacturing and nonresidential construction. Those data may not be enough to generate full confidence in our forecast for a much better second half of 2015, but they are moving in the right direction.

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July 1, 2015 in Economic Growth and Development, GDP | Permalink