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Worried about a Recession? Don't Blame Free Trade

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Speculation is growing that the U.S. economy may have already slipped into recession. If the past is any guide, politicians on the campaign trail will be tempted to blame trade and globalization for the passing pain of the business cycle. Rising unemployment and falling output can provide fertile ground for attacks on imports and foreign investment by U.S. multinational companies. But an analysis of previous recessions and expansions shows that international trade and investment are not to blame for downturns in the economy and may in fact be moderating the business cycle.

Economic downturns have occurred periodically throughout U.S. history. The popular definition of a recession is two consecutive quarters of negative growth in the nation's gross domestic product (GDP). The National Bureau of Economic Research in Cambridge, Massachusetts, which has become the official bookkeeper of the business cycle, offers a more refined definition: "A recession is a significant decline in activity spread across the economy, lasting more than a few months, visible in industrial production, employment, real income, and wholesale-retail trade."[1]

By NBER's accounting, the nation has suffered through 11 recessions since the end of World War II, not including the current possible downturn.[2] All recessions produce, to one degree or another, falling industrial output, lower real wages and household income, higher rates of unemployment, increased foreclosures and bankruptcies, and growing self-doubt about our economy and our country's future. In the political arena, recessions often spur a backlash against incumbent office holders, especially those of the president's party, and against foreign producers and foreign trade in general.

The supposed link between trade and recessions is superficially appealing. During any recession, critics can point to imports that displace domestic production, putting some U.S. workers out of their jobs and supposedly reducing domestic demand for goods and services. They can more easily blame U.S. multinational corporations for "shipping our jobs overseas" by locating production facilities in countries where labor and other costs are lower. But like so much of the conventional wisdom about trade and the economy, the alleged link between rising levels of trade and recessions simply does not exist.

"The Great Moderation"

In recent decades, as foreign trade and investment have been rising as a share of the U.S. economy, recessions have actually become milder and less frequent. The softening of the business cycle has become so striking that economists now refer to it as "The Great Moderation." The more benign trend appears to date from the mid-1980s. As a recent study from the Federal Reserve Bank of Dallas found:

> On average, the five recessions from 1959 to 1983 were 47 months apart, lingered 12 months and were associated with a 2.17 percent peak-to-trough decline in real gross domestic product. By contrast, the 1990 downturn came after 92 months of expansion, lasted eight months and involved a 1.26 percent decline in GDP. The 2001 slump ended a record 120 months of uninterrupted growth, lasted eight months and involved a GDP decline of only 0.35 percent. More generally, quarterly growth in both real GDP and jobs became markedly less volatile after 1983.[3]

The Great Moderation means that Americans are spending more of their time earning a living in a growing economy and less in a contracting economy. According to the NBER, our economy has been in recession a total of 16 months in the past 25 years, or 5.3 percent of the time. In comparison, between 1945 and 1983, the nation suffered through nine recessions totaling 96 months, or 21.1 percent of that time period.[4] (See Table 1.) In any given month, the country was four times more likely to be in recession in the post-war decades before 1983 than since then. And even if the U.S. economy has already entered a recession in 2008, the expansion that began after the 2001 recession would have lasted six years—making it the fourth-longest expansion since 1945.

Moderation of the business cycle has not come at the expense of overall growth. In the past 25 years (1983–2007),

Table 1
Economic Contractions Are Becoming Less Common

Time Period	Number of Contractions	Average Length		% of time in contraction
		Contractions	Expansions	
1855–1944	21	21 months	29 months	41
1945–1982	9	11 months	45 months	21
1983–2007	2	8 months	95 months	5

Source: National Bureau of Economic Research.

annual real GDP growth has averaged 3.3 percent. That is virtually the same average annual growth rate as occurred during the previous 25 years (1958–1982).[5] Like a superior investment, our more globalized economy has delivered the same rate of return in the form of real GDP growth but with much less volatility than in the past.

The more recent globalized growth also compares favorably with the supposed Golden Age of the late 19th and early 20th centuries, when U.S. manufacturers were protected by high tariffs. The era of protection so admired by skeptics of trade was also a time of dramatic boom and bust cycles. From 1854 to 1944, according to the NBER, the U.S. economy suffered 21 recessions averaging 21 months in length. During that time, despite tremendous growth, the U.S. economy was contracting 41 percent of the time. A depression in the 1870s lasted more than five years. The "Gay Nineties" (1890–99) and the "Roaring Twenties" (1920–29) each witnessed all or parts of four recessions.[6] And we should always remember that the Great Depression of the 1930s occurred on the protectionists' watch.

America's recent experience of a more globalized and less volatile economy has not been unique in the world. Other countries that have opened themselves to global markets have been less vulnerable to financial and economic shocks. Countries that put all their economic eggs in the domestic basket lack the diversification that a more globally integrated economy can fall back on to weather a slowdown. A study by Jeffrey Frankel and Eduardo Cavallo for NBER found that a country that increases trade as a share of its gross domestic product by 10 percentage points is actually about one-third less likely to suffer sudden economic slowdowns or other crises than if it were less open to trade. As the authors conclude:

> Some may find this counterintuitive: trade protectionism does not "shield" countries from the volatility of world markets as proponents might hope. On the contrary . . . economies that trade less with other countries are more prone to sudden stops and to currency crises.[7]

A More Diversified and Flexible Economy

Globalization is not the only possible cause behind the moderation of the business cycle. Improved monetary policy, fewer external shocks (what some economists call "good luck"), and other structural changes in the economy may have all played a role. For example, the decline in unionization and the resulting increase in labor-market flexibility have allowed wages and employment patterns to adjust more readily to changing market conditions, mitigating spikes in unemployment. Better inventory management through just-in-time delivery has reduced the cyclical overhangs that can disrupt production. Lifting the ceiling on deposit interest rates has helped lending institutions weather downturns, while more access to consumer credit and home equity loans have helped families smooth their consumption patterns over time when incomes temporarily fall.

Combined with those other factors, expanding trade and globalization have helped to moderate swings in national output by blessing us with a more diversified and flexible economy. Exports can take up slack when domestic demand sags, and imports can satisfy demand when domestic productive capacity is reaching its short-term limits. Access to foreign capital markets can allow domestic producers and consumers alike to more easily borrow to tide themselves over during difficult times.

During the current economic turmoil, as the housing and mortgage markets have turned downward, many U.S. companies have maintained or expanded production by serving growing global markets. In 2007, U.S. exports of goods and services rose a brisk 12.6 percent from the year before, more than double the growth rate of imports. Meanwhile, U.S. companies and investors saw their earnings on foreign assets grow an even faster 20.3 percent.[8]

A weakening dollar has helped to boost exports and earnings abroad, but the main driver of success overseas has been strong growth and lower trade barriers outside the United States. As *The Wall Street Journal* summarized in a front-page story: "Economies in most other parts of the world—including China, Latin America and Europe—have grown faster than the U.S. over the past 18 months, providing a countercyclical balance for multinational companies. Overseas growth could provide further support for companies and investors if parts of the U.S. economy continue to worsen."[9]

American companies have been earning a larger and larger share of their profits overseas for decades now. According to economist Ed Yardeni, the share of profits that U.S. companies earn abroad has increased steadily from about 5 percent in the 1960s to about a quarter of all profits today.[10]

Even the American icon Harley-Davidson motorcycle company in Milwaukee, Wisconsin, has become a multinational enterprise. The company that once came begging to Washington for protection from foreign competition is enjoying robust sales and profits abroad even as its domestic sales slump. In the second quarter of 2007, the company saw its profits jump by 19 percent—fueled by the double-digit growth in sales in Europe, Japan, and Canada—while its domestic sales fell 5.5 percent.[11]

Earning a larger share of profits abroad allows Harley-Davidson and other U.S. companies to better weather downturns at home, reducing the need for drastic cost cutting and layoffs when recessions hit.

Conclusion

If the U.S. economy does tip into recession this year, free trade and globalization will be among the likely scapegoats. The pain of recession will be real for millions of American households, but raising barriers to foreign trade and investment will provide no relief for most affected workers. In fact, reverting to protectionism would only reduce the capacity of our economy to regain its footing and resume its long-term pattern of growth.

For the U.S. economy as a whole, the era of globalization has brought healthy long-term growth and a moderation of the business cycle. Expansions are longer if less spectacular than in eras past, and downturns are mercifully shorter, shallower, and less frequent. Moderation of the business cycle in recent decades is something to be thankful for, and expanding trade and globalization deserve a share of the credit.

Notes

1. National Bureau of Economic Research, "The NBER's Recession Dating Procedure," www.nber.org/cycles/recessions.html.
2. NBER, "Business Cycle Expansions and Contractions," www.nber.org/cycles.html.
3. Evan F. Koenig and Nicole Ball, "The 'Great Moderation' in Output and Employment Volatility: An Update," Economic Letter, *Federal Reserve Bank of Dallas* 2, no. 9 (September 2007).
4. NBER, "Business Cycle Expansions and Contractions."
5. Bureau of Economic Analysis, National Economic Accounts, "Gross Domestic Product (GDP): Percent Change from Preceding Period," U.S. Department of Commerce, www.bea.gov/national/index.htm#gdp.
6. NBER, "Business Cycle Expansions and Contractions."
7. Jeffrey Frankel and Eduardo Cavallo, "Does Openness to Trade Make Countries More Vulnerable to Sudden Stops or Less? Using Gravity to Establish Causality," NBER Working Paper no. 10957, December 2004.
8. Bureau of Economic Analysis, "U.S. International Transactions: Fourth Quarter and Year 2007," U.S. Department of Commerce, News Release, Table 1, March 17, 2008.
9. Timothy Aeppel, "Overseas Profits Provide Shelter for U.S. Firms," *The Wall Street Journal*, August 9, 2007, p. A1.
10. Ibid.
11. Ibid.

CENTER FOR TRADE POLICY STUDIES

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Scholars at the Cato trade policy center recognize that open markets mean wider choices and lower prices for businesses and consumers, as well as more vigorous competition that encourages greater productivity and innovation. Those benefits are available to any country that adopts free trade policies; they are not contingent upon "fair trade" or a "level playing field" in other countries. Moreover, the case for free trade goes beyond economic efficiency. The freedom to trade is a basic human liberty, and its exercise across political borders unites people in peaceful cooperation and mutual prosperity.

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