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What's Behind the Surge in America's Imports?

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US imports posted a record surge during the second quarter, creating a new headwind to the economic recovery. With the US economy growing at a slower pace than the global average, a reversal of the import drag during the second half of 2010 would provide important support for GDP growth.

The US economy faced an unexpected headwind in the second quarter, as a surge in imports raised concerns of a new challenge to the recovery. During the second quarter, US imports rose by an annualized $126.8 billion **(Display 1)**, subtracting four percentage points from real GDP. In real dollar terms, it was the biggest quarterly leap in imports of the postwar period, and the subsequent damage to economic growth was unprecedented **(Display 2)**.

This puzzling development appears to contradict our *new mix* thesis for the US economy, which expects economic growth to be fueled by continued strength in exports. It also raises some big questions about the future trajectory of the recovery: First, why did US imports post a record surge amid modest domestic consumer demand, which is usually the main catalyst for rising imports? Second, was the spurt in imports a one-off aberration or should we expect a continuation of import growth that could undermine momentum for GDP expansion?

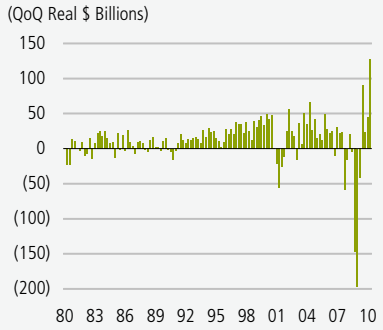
Our research shows that strong US exports are being driven primarily by a competitive manufacturing sector and robust growth in emerging markets, which in turn should deliver positive spillover effects on domestic capital spending. So far, this new mix of growth drivers has played out according to our expectations in the early stages of the US economic recovery that began in mid-2009. Contributions from exports and capital spending accounted for more than the overall gain in real GDP over the past year—the first time this has ever happened in the postwar period.

Import Growth Pace Exceeds Exports

Yet, the trend in imports does not fit. In an export-driven economy, against a backdrop of moderate domestic demand growth, the pace of import growth should be much slower than export growth. But in the second quarter, the initial GDP report showed imports advancing at an extremely rapid pace of 35.4% annualized—more than five times faster than exports. To make matters worse, the growth rate in imports will probably be revised even

Display 1
Imports Post Record Increase…

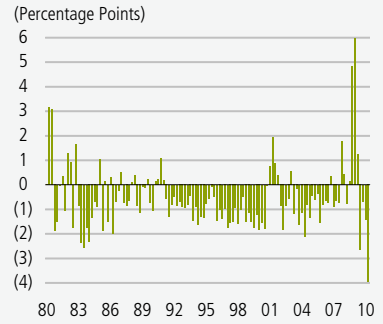
Growth in Real Merchandise Imports



As of June 2010
Source: Bureau of Economic Analysis and Haver Analytics

Display 2
…Inflicting Huge Damage to GDP

Real Merchandise Imports Contribution to Real GDP Growth



As of June 2010
Source: Bureau of Economic Analysis and Haver Analytics

higher following the release of June trade data last week.

The surge in imports from April to June was the largest quarterly gain since the second and third quarters of 1983, when imports increased by 36% and 39% respectively. Yet despite the similar pace of import growth, the surrounding environment is markedly different. In particular, during the middle quarters of 1983, consumer spending growth exceeded 10% on an annualized basis, while in the second quarter of this year, consumer spending on goods advanced by just 3%.

Domestic Demand Remains Weak

Import growth trends typically echo movements in domestic demand. Strong growth in domestic sales—especially consumer sales—tends to trigger a solid rise in imports. In contrast, weak or modest domestic demand growth is usually accompanied by small gains in imports, and occasionally even a decline.

According to the GDP data, about 37% of the record gain in real imports during the second quarter was concentrated in consumer durable and nondurable goods **(Display 3)**. Half of the increase came from the motor vehicle sector as US firms began to rebuild inventory positions by importing products from their manufacturing plants in Canada and Mexico. Much of the remaining consumer good imports were nondurables, with pharmaceuticals accounting for about a third of the gains.

Real capital goods imports accounted for about 37% of the second-quarter gain, with technology products contributing about a third of the increase. Trade flows of technology products are a double-edged sword for the US economy.

Although many ideas and designs behind some of the most popular technology products originate in the US, almost all US technology companies produce these items abroad. In these cases, the transfer of the idea, design or blueprint is not counted as a US export, while the final assembled product that returns to the US for sale is counted as an import.

Of course, the US economy and real GDP growth reap great benefits from innovation and new products, as the value added to the economy is roughly five to six times larger than the price of the imported product. However, as long as US companies rely upon foreign affiliates or alliances to produce most of their technology products, any technology-driven capital spending cycle will be accompanied by a strong gain in imports. The benefit to the US comes from strong job creation in computer design and technical services as well as through large profits to those firms that invent innovative products.

Most of the rest (22%) of the import surge was concentrated in petroleum and related products. The $28.4 billion increase in real petroleum products followed declines in five of the last six quarters, so the rise in the second quarter reflected a normal restocking phase that is common in the early stages of economic recovery. Total product inventories are now back to near record highs, meaning a modest reversal in petroleum imports is likely over the near term, which may help reverse the import boom from the second quarter that hurt economic growth.

Challenge to New Mix?

Clearly, the import data for the second quarter pose a significant challenge to our forecast and to our *new mix* macroeconomic theme for the US economy. That's because further import growth would suggest that non-US production may be squeezing out domestic production, further weakening the domestic labor market in the process.

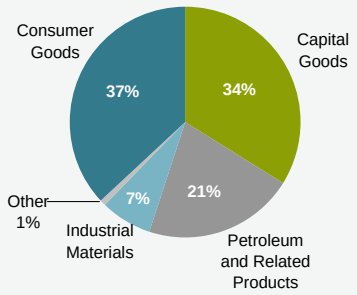
However, we're not convinced that the recent import gains will persist. Without the fundamental support of strong consumer demand growth, imports lack a crucial magnet and the recent pace of growth is unlikely to be sustained. Indeed, during the second quarter, the dollar increase in real consumer goods imports was double the dollar increase in consumer spending on goods, indicating that many recent imports are still sitting on retailer shelves or in dealer inventories.

Moreover, we expect consumer spending to increase by a modest 2% to 2.25% in the second half, which implies the growth in imports of consumer goods is likely to slow dramatically from the pace in the second quarter. Away from the consumer sector, the volume of petroleum imports has already started to trend lower following the surge in the second quarter to a near record level of oil inventories.

On the other hand, as manufacturing production continued to enjoy a strong and broad-based rebound in July, export demand still looks firm. This trend is supported by ongoing strength in export orders in the ISM manufacturing survey. On balance, the strong export trend appears much more durable than the recent swell in imports, and we view the poor trade data in the second quarter as a hiccup rather than a reversal in the US economy's growth trend. ■

Display 3
Increase in Imports Was Broad Based

Composition of Real Merchandise Import Growth in 2Q:2010



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