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Why They Can't All Be Trade Surpluses

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As the potential for a trade war with China escalates, and the rhetoric about NAFTA continues to heat up, we thought we'd step back and talk a bit about the perception underlying current political concern regarding trade: trade deficits. President Trump's comments early in March stated that the U.S. has a deficit with almost every county—something that just isn't true. But this perception that trade deficits mean that, according to President Trump, "we lost, over the last number of years, $800 billion a year," raises questions about what a trade deficit is and how it's measured.

In its purest form, a trade deficit occurs when a county imports more goods than it exports, also known as a negative balance of trade. To calculate a deficit (or surplus), you subtract the total value of exports from the total value of imports. In 2017, the U.S. had a total trade deficit of $566 billion for both goods and services. While the U.S. is running a trade deficit, it's in just one particular component of trade—goods – totaling $811 billion in 2017. When it comes to services, the U.S. is a net exporter, exporting $788 billion in services, while only importing $534 billion. That makes for a total surplus in services of $244 billion, helping offset the $811 billion deficit in goods for a total deficit of $566 billion.

Trade deficits are not a particularly good measure of the 'health' of a bilateral trade relationship. For example, when raw materials are sent abroad, they are counted as exports, and when finished goods return home, they are counted as imports. Imagine that the U.S. exports parts worth $100, then these parts are assembled abroad, and re-imported back to the U.S. for $120. The value of the final good is the sum of its parts and the labor used for assembly, so the value of the import is more than the value of the export. But while this exchange results in a trade deficit, the vast majority of the value of that good is going back to the parts producers located in the U.S. Further, if the assembly is being done by the U.S. company itself, when (and if) those profits are repatriated into the U.S., taxes on the profits from that good are adding to U.S. government revenue. For a good real-world example, consider the iPhone, the trade of which contributes to our trade deficit with China. Only around 4 percent of the value of the iPhone actually comes from its assembly in China, and the true underlying producers of the value of that iPhone are located across the world in the U.S., South Korea, Taiwan and the European Union. Further complicating the accounting of trade balance are goods that "pass-through" one country on the way to another, an issue that leads two nations to have different trade numbers.

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One thing that makes running a trade deficit very different than if a private business is selling less than it buys is that trade deficits are balanced by the value of the dollar and international investment. Dollars are both a medium for exchange, but they're also a commodity in and of themselves. So if more people want to get U.S. dollars, to say, invest in U.S. companies, or buy U.S. goods, that will drive the price of the dollar up relative to other currencies. For example, if the U.S. economy is seen as a good place to invest, those inflows of capital from other countries will lead to an increase in the value of the U.S. dollar. That, in turn, makes our export goods relatively more expensive, since they need to be paid for in these more expensive dollars. So, running a trade deficit does not necessarily mean that the economy is stumbling—in fact it can signal the exact opposite—that the economy is growing, is a place to invest, and is wealthy enough for consumers to want to buy more goods. Conversely, our trade deficit fell substantially during the great recession, but that was because U.S. consumers had less money to buy goods, including imported goods. So having a trade deficit does not inherently mean that the economy is in bad shape, and running a surplus is not inherently a good thing.

The balance of trade is only part of a broader measure, known as the current account, which, with the financial and capital accounts, make up a country's balance of payments. The current account measures trade, plus transfers of capital. When it comes to transfers of capital, The Bureau of Economic Analysis specifies three types; international income, direct transfers of capital, and asset income. Foreign income (net income) is the second largest piece of the current account and includes income earned on foreign assets and income earned by working abroad. Direct transfers include foreign aid and foreign direct investments, as well as bank loans to foreigners. And asset income is the increase or decrease in assets, such as bank deposits, the federal reserves, securities, and real estate. If assets do well, then income is high. Also, foreign-owned U.S. assets are subtracted out. Thus, a country that is successfully attracting investment from abroad, by definition, will run a current account deficit, whereas a country with a great deal of savings that are being invested in foreign firms will run a current account surplus. As of March 21, the U.S. has a preliminary current account deficit of $466.2 billion for 2017.

This is not to say that trade deficits are inherently good. The surge in imports from 2000 to 2008 may have cost the U.S. economy a substantial number of jobs. So if we want to reduce our trade deficit, be more competitive and produce more in the U.S., how do we go about that? We can begin answering that question by eliminating things that we know do not work. For example, tariffs aren't a particularly good solution for a number of reasons. The first reason is the issue with the interconnectedness of the global economy. Placing tariffs on steel imports, for example, hurts U.S. manufactures of goods that use steel, and makes their exports less competitive. Second, unless one places tariffs on imports from all countries, all we may be doing is making the U.S. steel market more attractive for steel producers located in other, non-tariff-facing countries. Third, there is retaliation. Like we're currently facing with China, when we impose tariffs on imports from one country, that country will likely retaliate against our exports. That can both hurt the overall global economy by slowing economic growth, and it can help our competitors by making their products relatively more affordable in the targeted market. Fourth, as a longer-run issue, imposing tariffs, particularly using the non-standard and potentially wide-reaching justification of 'national security,' makes us an unreliable trading partner, making it harder for us to reach favorable trade agreements in the future. To use a simple example, I have a long-run trade deficit with my local grocery store. I would not want to try and 'solve' that trade deficit by imposing 'taxes' on all of my food 'imports' since the primary person who would be hurt by that would be me.

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