

Chapter 23

Unemployment

Introduction to the International Trade and Capital Flows

The **balance of trade** (or trade balance) is any gap between a nation's dollar value of its exports, or what its producers sell abroad, and a nation's dollar value of imports, or the foreign-made products and services that households and businesses purchase. Recall from The Macroeconomic Perspective that if exports exceed imports, the economy has a trade surplus. If imports exceed exports, the economy has a trade deficit. If exports and imports are equal, then trade is balanced, but what happens when trade is out of balance and large trade surpluses or deficits exist?

Germany, for example, has had substantial trade surpluses in recent decades, in which exports have greatly exceeded imports. According to the World Bank, in 2020, Germany ran a trade surplus of \$242 billion. In contrast, the U.S. economy in recent decades has experienced large trade deficits, in which imports have considerably exceeded exports. In 2020, for example, U.S. imports exceeded exports by \$651 billion.

A series of financial crises triggered by unbalanced trade can lead economies into deep recessions. These crises begin with large trade deficits. At some point, foreign investors become pessimistic about the economy and move their money to other countries. The economy then drops into deep recession, with real GDP often falling up to 10% or more in a single year. This happened to Mexico in 1995 when their GDP fell 8.1%. A number of countries in East Asia—Thailand, South Korea, Malaysia, and Indonesia—succumbed to the same economic illness in 1997–1998 (called the Asian Financial Crisis). In the late 1990s and into the early 2000s, Russia and Argentina had the identical experience. What are the connections between imbalances of trade in goods and services and the flows of international financial capital that set off these economic avalanches?

We will start by examining the balance of trade in more detail, by looking at some patterns of trade balances in the United States and around the world. Then we will examine the intimate connection between international flows of goods and services and international flows of financial capital, which to economists are really just two sides of the same coin. People often assume that trade surpluses like those in Germany must be a positive sign for an economy, while trade deficits like those in the United States must be harmful. As it turns out, both trade surpluses and deficits can be either good or bad. We will see why in this chapter.

23.1 Measuring Trade Balances

A few decades ago, it was common to track the solid or physical items that planes, trains, and trucks transported between countries as a way of measuring the balance of trade. Economists call this measurement the **merchandise trade balance**. In most high-income economies, including the United States, goods comprise less than half of a country's total production, while services comprise more than half. The last two decades have seen a surge in international trade in services, powered by technological advances in telecommunications and computers that have made it possible to export or import customer services, finance, law, advertising, management consulting, software, construction engineering, and product design. Most global trade still takes the form of goods rather than services, and the government announces and the media

prominently report the merchandise trade balance. Old habits are hard to break. Economists, however, typically rely on broader measures such as the balance of trade or the **current account balance** which includes other international flows of income and foreign aid.

Components of the U.S. Current Account Balance

Table 23.1 breaks down the four main components of the U.S. current account balance for the last quarter of 2015 (seasonally adjusted). The first line shows the merchandise trade balance; that is, exports and imports of goods. Because imports exceed exports, the trade balance in the final column is negative, showing a merchandise trade deficit.

| | Value of Exports (money flowing into the United States) | Value of Imports (money flowing out of the United States) | Balance |
|--------------------------------|--|--|-----------------|
| Goods | \$1,428.8 | \$2,350.8 | −\$922.0 |
| Services | \$705.6 | \$460.3 | \$245.3 |
| Income receipts and payments | \$957.9 | \$769.4 | \$188.5 |
| Unilateral transfers | \$166.3 | \$294.2 | −\$127.9 |
| Current account balance | \$3,258.6 | \$3,874.7 | −\$616.1 |

Table 23.1 Components of the U.S. Current Account Balance for 2020 (in billions of dollars). Source: <https://apps.bea.gov/itable/index.cfm>, ITA Table 1.1.

The second row of Table 23.1 provides data on trade in services. Here, the U.S. economy is running a surplus. Although the level of trade in services is still relatively small compared to trade in goods, the importance of services has expanded substantially over the last few decades. For example, U.S. exports of services were equal to about one-half of U.S. exports of goods in 2020, compared to one-fifth in 1980.

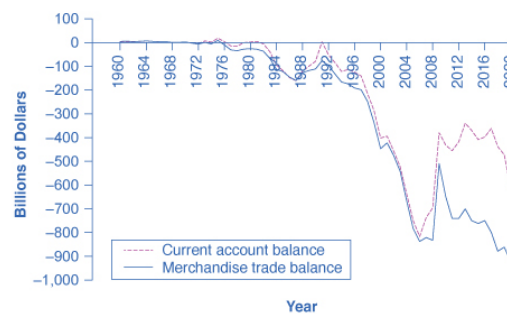
The third component of the current account balance, labeled “income payments,” refers to money that U.S. financial investors received on their foreign investments (money flowing into the United States) and payments to foreign investors who had invested their funds here (money flowing out of the United States). The reason for including this money on foreign investment in the overall measure of trade, along with goods and services, is that, from an economic perspective, income is just as much an economic transaction as car, wheat, or oil shipments: it is just trade that is happening in the financial capital market.

The final category of the current account balance is **unilateral transfers**, which are payments that government, private charities, or individuals make in which they send money abroad without receiving any direct good or service. Economic or military assistance from the U.S. government

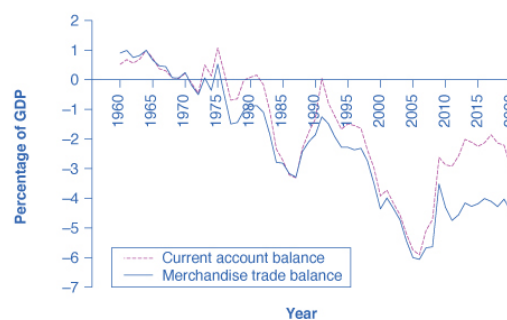
to other countries fits into this category, as does spending abroad by charities to address poverty or social inequalities. When an individual in the United States sends money overseas, as is the case with some immigrants, it is also counted in this category. The current account balance treats these unilateral payments like imports, because they also involve a stream of payments leaving the country. For the U.S. economy, unilateral transfers are almost always negative. This pattern, however, does not always hold. In 1991, for example, when the United States led an international coalition against Saddam Hussein's Iraq in the Gulf War, many other nations agreed that they would make payments to the United States to offset the U.S. war expenses. These payments were large enough that, in 1991, the overall U.S. balance on unilateral transfers was a positive \$10 billion.

23.2 Trade Balances in Historical and International Context

We present the history of the U.S. current account balance in recent decades in several different ways. [Figure 23.2 \(a\)](#) shows the current account balance and the merchandise trade balance—the latter of which is simply the balance on goods exported versus imported—in dollar terms. [Figure 23.2 \(b\)](#) shows the current account balance and merchandise account balance yet again, this time as a share of the GDP for that year. By dividing the trade deficit in each year by GDP in that year, [Figure 23.2 \(b\)](#) factors out both inflation and growth in the real economy.



(a) The current account and merchandise trade balance in nominal dollars



(b) The current account and merchandise trade balance as a percentage of GDP

Figure 23.2 Current Account Balance and Merchandise Trade Balance, 1960–2020 (a) The current account balance and the merchandise trade balance in billions of dollars from 1960 to 2020. The merchandise trade balance is the trade balance on goods only. If the lines are above zero dollars, the United States was running a positive trade balance and current account balance. If the lines fall below zero dollars, the United States is running a trade deficit and a deficit in its current account balance. (b) This shows the same items—trade balance and current account

balance—in relationship to the size of the U.S. economy, or GDP, from 1960 to 2020.

By either measure, the U.S. balance of trade pattern is clear. From the 1960s into the 1970s, the U.S. economy had mostly small trade surpluses—that is, the graphs in [Figure 23.2](#) show positive numbers. However, starting in the 1980s, the trade deficit increased rapidly, and after a tiny surplus in 1991, the current account trade deficit became even larger in the late 1990s and into the mid-2000s. However, the trade deficit declined in 2009 after the recession had taken hold, then rebounded partially in 2010 and remained stable up through 2019, before falling again in 2020.

Current Account Balance in Billions of Dollars.

[Table 23.4](#) shows the U.S. trade picture in 2013 compared with some other economies from around the world. While the U.S. economy has consistently run trade deficits in recent years, Japan and many European nations, among them France and Germany, have consistently run trade surpluses. Some of the other countries listed include Brazil, the largest economy in Latin America; Nigeria, along with South Africa competing to be the largest economy in Africa; and China, India, and Korea. The first column offers one measure of an economy's globalization: **exports of goods and services as a percentage of GDP**. The second column shows the trade balance. Usually, most countries have trade surpluses or deficits that are less than 5% of GDP. As you can see, the U.S. current account balance is -2.6% of GDP, while Germany's is 8.4% of GDP.

| | Exports of Goods and Services | Current Account Balance |
|----------------|-------------------------------|-------------------------|
| United States | 10.2% | -2.9% |
| Japan | 15.5% | 3.2% |
| Germany | 43.4% | 7.0% |
| United Kingdom | 27.9% | -2.6% |
| Canada | 29.0% | -1.8% |
| Sweden | 44.6% | 5.7% |
| Korea | 36.4% | 4.6% |
| Mexico | 40.2% | 2.4% |
| Brazil | 16.9% | -1.8% |
| China | 18.5% | 1.9% |
| India | 18.7% | 1.2% |

| | Exports of Goods and Services | Current Account Balance |
|---------|-------------------------------|-------------------------|
| Nigeria | 8.8% | −3.9% |
| World | - | 0.0% |

Table 23.4 Level and Balance of Trade (Balance of Payments basis) in 2020 (figures as a percentage of GDP, Source: <http://data.worldbank.org/indicator/BN.CAB.XOKA.GD.ZS>)

23.3 Trade Balances and Flows of Financial Capital

As economists see it, trade surpluses can be either good or bad, depending on circumstances, and trade deficits can be good or bad, too. The challenge is to understand how the international flows of goods and services are connected with international flows of **financial capital**. In this module we will illustrate the intimate connection between trade balances and flows of financial capital in two ways: a parable of trade between Robinson Crusoe and Friday, and a circular flow diagram representing flows of trade and payments.

A Two-Person Economy: Robinson Crusoe and Friday

To understand how economists view trade deficits and surpluses, consider a parable based on the story of Robinson Crusoe. Crusoe, as you may remember from the classic novel by Daniel Defoe first published in 1719, was shipwrecked on a desert island. After living alone for some time, he is joined by a second person, whom he names Friday. Think about the balance of trade in a two-person economy like that of Robinson and Friday.

Robinson and Friday trade goods and services. Perhaps Robinson catches fish and trades them to Friday for coconuts, or Friday weaves a hat out of tree fronds and trades it to Robinson for help in carrying water. For a period of time, each individual trade is self-contained and complete. Because each trade is voluntary, both Robinson and Friday must feel that they are receiving fair value for what they are giving. As a result, each person's exports are always equal to his imports, and trade is always in balance between the two. Neither person experiences either a trade deficit or a trade surplus.

However, one day Robinson approaches Friday with a proposition. Robinson wants to dig ditches for an irrigation system for his garden, but he knows that if he starts this project, he will not have much time left to fish and gather coconuts to feed himself each day. He proposes that Friday supply him with a certain number of fish and coconuts for several months, and then after that time, he promises to repay Friday out of the extra produce that he will be able to grow in his irrigated garden. If Friday accepts this offer, then a trade imbalance comes into being. For several months, Friday will have a trade surplus: that is, he is exporting to Robinson more than he is importing. More precisely, he is giving Robinson fish and coconuts, and at least for the moment, he is receiving nothing in return. Conversely, Robinson will have a trade deficit, because he is importing more from Friday than he is exporting.

This parable raises several useful issues in thinking about what a trade deficit and a trade surplus really mean in economic terms. The first issue that this story of Robinson and Friday raises is this: Is it better to have a trade surplus or a trade deficit? The answer, as in any voluntary market

interaction, is that if both parties agree to the transaction, then they may both be better off. Over time, if Robinson's irrigated garden is a success, it is certainly possible that both Robinson and Friday can benefit from this agreement.

The parable raises a second issue: What can go wrong? Robinson's proposal to Friday introduces an element of uncertainty. Friday is, in effect, making a loan of fish and coconuts to Robinson, and Friday's happiness with this arrangement will depend on whether Robinson repays that loan as planned, in full and on time. Perhaps Robinson spends several months loafing and never builds the irrigation system, or perhaps Robinson has been too optimistic about how much he will be able to grow with the new irrigation system, which turns out not to be very productive. Perhaps, after building the irrigation system, Robinson decides that he does not want to repay Friday as much as he previously agreed. Any of these developments will prompt a new round of negotiations between Friday and Robinson. Why the repayment failed is likely to shape Friday's attitude toward these renegotiations. If Robinson worked very hard and the irrigation system just did not increase production as intended, Friday may have some sympathy. If Robinson loafed or if he just refuses to pay, Friday may become irritated.

A third issue that the parable raises is that an intimate relationship exists between a trade deficit and international borrowing, and between a trade surplus and international lending. The size of Friday's trade surplus is exactly how much he is lending to Robinson. The size of Robinson's trade deficit is exactly how much he is borrowing from Friday. To economists, a trade surplus literally means the same thing as an outflow of financial capital, and a trade deficit literally means the same thing as an inflow of financial capital. This last insight is worth exploring in greater detail, which we will do in the following section.

The story of Robinson and Friday also provides a good opportunity to consider the law of comparative advantage, which you learn more about in the International Trade chapter.

The Balance of Trade as the Balance of Payments

The connection between trade balances and international flows of financial capital is so close that economists sometimes describe the balance of trade as the balance of payments. Each category of the current account balance involves a corresponding flow of payments between a given country and the rest of the world economy.

Figure 23.3 shows the flow of goods and services and payments between one country—the United States in this example—and the rest of the world. The top line shows U.S. exports of goods and services, while the second line shows financial payments from purchasers in other countries back to the U.S. economy. The third line then shows U.S. imports of goods, services, and investment, and the fourth line shows payments from the home economy to the rest of the world. Flow of goods and services (lines one and three) show up in the current account, while we find flow of funds (lines two and four) in the financial account.

The bottom four lines in Figure 23.3 show the flows of investment income. In the first of the bottom lines, we see investments made abroad with funds flowing from the home country to the rest of the world. Investment income stemming from an investment abroad then runs in the other direction from the rest of the world to the home country. Similarly, we see on the bottom third

line, an investment from the rest of the world into the home country and investment income (bottom fourth line) flowing from the home country to the rest of the world. We find the investment income (bottom lines two and four) in the current account, while investment to the rest of the world or into the home country (lines one and three) is in the financial account. This figure does not show unilateral transfers, the fourth item in the current account.

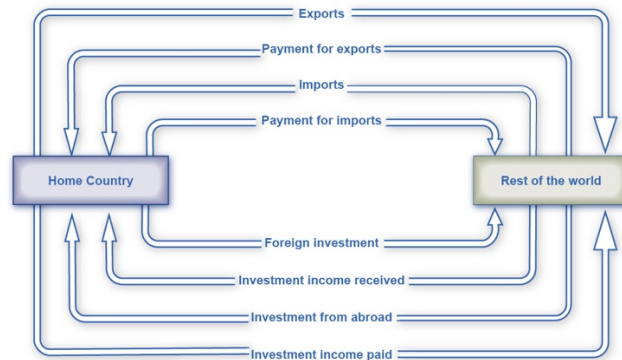


Figure 23.3 Flow of Investment Goods and Capital Each element of the current account balance involves a flow of financial payments between countries. The top line shows exports of goods and services leaving the home country; the second line shows the money that the home country receives for those exports. The third line shows imports that the home country receives; the fourth line shows the payments that the home country sent abroad in exchange for these imports.

A current account deficit means that, the country is a net borrower from abroad. Conversely, a positive current account balance means a country is a net lender to the rest of the world. Just like the parable of Robinson and Friday, the lesson is that a trade surplus means an overall outflow of financial investment capital, as domestic investors put their funds abroad, while a deficit in the current account balance is exactly equal to the overall or net inflow of foreign investment capital from abroad.

It is important to recognize that an inflow and outflow of foreign capital does not necessarily refer to a debt that governments owe to other governments, although government debt may be part of the picture. Instead, these international flows of financial capital refer to all of the ways in which private investors in one country may invest in another country—by buying real estate, companies, and financial investments like stocks and bonds.

23.4 The National Saving and Investment Identity

The close connection between trade balances and international flows of savings and investments leads to a macroeconomic analysis. This approach views trade balances—and their associated flows of financial capital—in the context of the overall levels of savings and financial investment in the economy.

Understanding the Determinants of the Trade and Current Account Balance

The **national saving and investment identity** provides a useful way to understand the determinants of the trade and current account balance. In a nation's financial capital market, the quantity of financial capital supplied at any given time must equal the quantity of financial capital demanded for purposes of making investments.

There are two main sources for the supply of financial capital in the U.S. economy: saving by individuals and firms, called S , and the inflow of financial capital from foreign investors, which is equal to the trade deficit ($M - X$), or imports minus exports. There are also two main sources of demand for financial capital in the U.S. economy: private sector investment, I , and government borrowing, where the government needs to borrow when government spending, G , is higher than the taxes collected, T .

However, certain components of the national savings and investment identity can switch between the supply side and the demand side. Some countries, like the United States in most years since the 1970s, have budget deficits, which mean the government is spending more than it collects in taxes, and so the government needs to borrow funds. In this case, the government term would be $G - T > 0$, showing that spending is larger than taxes, and the government would be a demander of financial capital on the right-hand side of the equation (that is, a borrower), not a supplier of financial capital on the left-hand side. However, if the government runs a budget surplus so that the taxes exceed spending, as the U.S. government did from 1998 to 2001, then the government in that year was contributing to the supply of financial capital ($T - G > 0$), and would appear on the left (supplier or saving) side of the national savings and investment identity.

Similarly, if a national economy runs a trade surplus, the trade sector will involve an outflow of financial capital to other countries. A trade surplus means that the domestic financial capital is in surplus within a country and can be invested in other countries.

The fundamental notion that total quantity of financial capital demanded equals total quantity of financial capital supplied must always remain true. Domestic savings will always appear as part of the supply of financial capital and domestic investment will always appear as part of the demand for financial capital. However, the government and trade balance elements of the equation can move back and forth as either suppliers or demanders of financial capital, depending on whether government budgets and the trade balance are in surplus or deficit.

Domestic Saving and Investment Determine the Trade Balance

One insight from the national saving and investment identity is that a nation's own levels of domestic saving and investment determine a nation's balance of trade. To understand this point, rearrange the identity to put the balance of trade all by itself on one side of the equation.

As another scenario, imagine that the government budget deficit increased dramatically, while domestic investment and private savings remained unchanged. This scenario occurred in the U.S. economy in the mid-1980s. The federal budget deficit increased from \$79 billion in 1981 to \$221 billion in 1986—an increase in the demand for financial capital of \$142 billion. The current account balance collapsed from a surplus of \$5 billion in 1981 to a deficit of \$147 billion in 1986—an increase in the supply of financial capital from abroad of \$152 billion. The connection at that time is clear: a sharp increase in government borrowing increased the U.S. economy's demand for financial capital, and foreign investors through the trade deficit primarily supplied that increase. The following Work It Out feature walks you through a scenario in which private domestic savings has to rise by a certain amount to reduce a trade deficit.

Short-Term Movements in the Business Cycle and the Trade Balance

In the short run, whether an economy is in a recession or on the upswing can affect trade imbalances. A recession tends to make a trade deficit smaller, or a trade surplus larger, while a period of strong economic growth tends to make a trade deficit larger, or a trade surplus smaller. These are not hard-and-fast rules, however.

As an example, note in [Figure 23.2](#) that the U.S. trade deficit declined by almost half from 2006 to 2009. One primary reason for this change is that during the recession, as the U.S. economy slowed down, it purchased fewer of all goods, including fewer imports from abroad. However, buying power abroad fell less, and so U.S. exports did not fall by as much. On the other hand, during the 2020 pandemic-induced recession, the trade deficit expanded (current account balance plummeted) as the U.S. economy became more reliant on other countries for goods and services.

Conversely, in the mid-2000s, when the U.S. trade deficit became very large, a contributing short-term reason is that the U.S. economy was growing. As a result, there was considerable aggressive buying in the U.S. economy, including the buying of imports. Thus, a trade deficit (or a much lower trade surplus) often accompanies a rapidly growing domestic economy, while a trade surplus (or a much lower trade deficit) accompanies a slowing or recessionary domestic economy.

Regardless of whether the trade deficit falls or rises during expansions or downturns, when the trade deficit rises, it necessarily means a greater net inflow of foreign financial capital. The national saving and investment identity teaches that the rest of the economy can absorb this inflow of foreign financial capital in several different ways. For example, reduced private savings could offset the additional inflow of financial capital from abroad, leaving domestic investment and public saving unchanged. Alternatively, the inflow of foreign financial capital could result in higher domestic investment, leaving private and public saving unchanged. Yet another possibility is that greater government borrowing could absorb the inflow of foreign financial capital, leaving domestic saving and investment unchanged. The national saving and investment identity does not specify which of these scenarios, alone or in combination, will occur—only that one of them must occur.

23.5 The Pros and Cons of Trade Deficits and Surpluses

Because flows of trade always involve flows of financial payments, flows of international trade are actually the same as flows of international financial capital. The question of whether trade deficits or surpluses are good or bad for an economy is, in economic terms, exactly the same question as whether it is a good idea for an economy to rely on net inflows of financial capital from abroad or to make net investments of financial capital abroad. Conventional wisdom often holds that borrowing money is foolhardy, and that a prudent country, like a prudent person, should always rely on its own resources. While it is certainly possible to borrow too much—as anyone with an overloaded credit card can testify—borrowing at certain times can also make sound economic sense. For both individuals and countries, there is no economic merit in a policy of abstaining from participation in financial capital markets.

It makes economic sense to borrow when you are buying something with a long-run payoff; that is, when you are making an investment. For this reason, it can make economic sense to borrow

for a college education, because the education will typically allow you to earn higher wages, and so to repay the loan and still come out ahead. It can also make sense for a business to borrow in order to purchase a machine that will last 10 years, as long as the machine will increase output and profits by more than enough to repay the loan. Similarly, it can make economic sense for a national economy to borrow from abroad, as long as it wisely invests the money in ways that will tend to raise the nation's economic growth over time. Then, it will be possible for the national economy to repay the borrowed money over time and still end up better off than before.

One vivid example of a country that borrowed heavily from abroad, invested wisely, and did perfectly well is the United States during the nineteenth century. The United States ran a trade deficit in 40 of the 45 years from 1831 to 1875, which meant that it was importing capital from abroad over that time. However, that financial capital was mostly invested in projects like railroads that brought a substantial economic payoff.

A more recent example along these lines is the experience of South Korea, which had trade deficits during much of the 1970s—and so was an importer of capital over that time. However, South Korea also had high rates of investment in physical plant and equipment, and its economy grew rapidly. From the mid-1980s into the mid-1990s, South Korea often had trade surpluses—that is, it was repaying its past borrowing by sending capital abroad.

In contrast, some countries have run large trade deficits, borrowed heavily in global capital markets, and ended up in all kinds of trouble. Two specific sorts of trouble are worth examining. First, a borrower nation can find itself in a bind if it does not invest the incoming funds from abroad in a way that leads to increased productivity. Several of Latin America's large economies, including Mexico and Brazil, ran large trade deficits and borrowed heavily from abroad in the 1970s, but the inflow of financial capital did not boost productivity sufficiently, which meant that these countries faced enormous troubles repaying the money borrowed when economic conditions shifted during the 1980s. Similarly, it appears that a number of African nations that borrowed foreign funds in the 1970s and 1980s did not invest in productive economic assets. As a result, several of those countries later faced large interest payments, with no economic growth to show for the borrowed funds.

A second “trouble” is: What happens if the foreign money flows in, and then suddenly flows out again? We raised this scenario at the start of the chapter. In the mid-1990s, a number of countries in East Asia—Thailand, Indonesia, Malaysia, and South Korea—ran large trade deficits and imported capital from abroad. However, in 1997 and 1998 many foreign investors became concerned about the health of these economies, and quickly pulled their money out of stock and bond markets, real estate, and banks. The extremely rapid departure of that foreign capital staggered the banking systems and economies of these countries, plunging them into deep recession. We investigate and discuss the links between international capital flows, banks, and recession in *The Impacts of Government Borrowing*.

While a trade deficit is not always harmful, there is no guarantee that running a trade surplus will bring robust economic health. For example, Germany and Japan ran substantial trade surpluses for most of the last three decades. Regardless of their persistent trade surpluses, both countries

have experienced occasional recessions and neither country has had especially robust annual growth in recent years. Read more about Japan's trade surplus in the next Clear It Up feature.

The sheer size and persistence of the U.S. trade deficits and inflows of foreign capital since the 1980s are a legitimate cause for concern. The huge U.S. economy will not be destabilized by an outflow of international capital as easily as, say, the comparatively tiny economies of Thailand and Indonesia were in 1997–1998. Even an economy that is not knocked down, however, can still be shaken. American policymakers should certainly be paying attention to those cases where a pattern of extensive and sustained current account deficits and foreign borrowing has gone badly—if only as a cautionary tale.

23.6 The Difference between Level of Trade and the Trade Balance

A nation's *level* of trade may at first sound like much the same issue as the *balance* of trade, but these two are actually quite separate. It is perfectly possible for a country to have a very high level of trade—measured by its exports of goods and services as a share of its GDP—while it also has a near-balance between exports and imports. A high level of trade indicates that the nation exports a good portion of its production. It is also possible for a country's trade to be a relatively low share of GDP, relative to global averages, but for the imbalance between its exports and its imports to be quite large. We emphasized this general theme earlier in Measuring Trade Balances, which offered some illustrative figures on trade levels and balances.

A country's level of trade tells how much of its production it exports. We measure this by the percent of exports out of GDP. It indicates the degree of an economy's globalization. Some countries, such as Germany, have a high level of trade—they export almost 50% of their total production. The balance of trade tells us if the country is running a trade surplus or trade deficit. A country can have a low level of trade but a high trade deficit. (For example, the United States only exports around 10% of its GDP, but it has a trade deficit of over \$600 billion.)

Three factors strongly influence a nation's level of trade: the size of its economy, its geographic location, and its history of trade. Large economies like the United States can do much of their trading internally, while small economies like Sweden have less ability to provide what they want internally and tend to have higher ratios of exports and imports to GDP. Nations that are neighbors tend to trade more, since costs of transportation and communication are lower. Moreover, some nations have long and established patterns of international trade, while others do not.

Consequently, a relatively small economy like Sweden, with many nearby trading partners across Europe and a long history of foreign trade, has a high level of trade. Brazil and India, which are fairly large economies that have often sought to inhibit trade in recent decades, have lower levels of trade; whereas, the United States and Japan are extremely large economies that have comparatively few nearby trading partners. Both countries actually have quite low levels of trade by world standards. The ratio of exports to GDP in either the United States or in Japan is about half of the world average.

The balance of trade is a separate issue from the level of trade. The United States has a low level of trade, but had enormous trade deficits for most years from the mid-1980s into the 2000s.

Japan has a low level of trade by world standards, but has typically shown large trade surpluses in recent decades. Nations like Germany and the United Kingdom have medium to high levels of trade by world standards, but Germany had a moderate trade surplus in 2020, while the United Kingdom had a moderate trade deficit. Their trade picture was roughly in balance in the late 1990s. Sweden had a high level of trade and a moderate trade surplus in 2020, while Canada had a high level of trade and a moderate trade deficit that same year.

In short, it is quite possible for nations with a relatively low level of trade, expressed as a percentage of GDP, to have relatively large trade deficits. It is also quite possible for nations with a near balance between exports and imports to worry about the consequences of high levels of trade for the economy. It is not inconsistent to believe that a high level of trade is potentially beneficial to an economy, because of the way it allows nations to play to their comparative advantages, and to also be concerned about any macroeconomic instability caused by a long-term pattern of large trade deficits.

Final Thoughts about Trade Balances

Trade deficits can be a good or a bad sign for an economy, and trade surpluses can be a good or a bad sign. Even a trade balance of zero—which just means that a nation is neither a net borrower nor lender in the international economy—can be either a good or bad sign. The fundamental economic question is not whether a nation’s economy is borrowing or lending at all, but whether the particular borrowing or lending in the particular economic conditions of that country makes sense.

It is interesting to reflect on how public attitudes toward trade deficits and surpluses might change if we could somehow change the labels that people and the news media affix to them. If we called a trade deficit “attracting foreign financial capital”—which accurately describes what a trade deficit means—then trade deficits might look more attractive. Conversely, if we called a trade surplus “shipping financial capital abroad”—which accurately captures what a trade surplus does—then trade surpluses might look less attractive. Either way, the key to understanding trade balances is to understand the relationships between flows of trade and flows of international payments, and what these relationships imply about the causes, benefits, and risks of different kinds of trade balances. The first step along this journey of understanding is to move beyond knee-jerk reactions to terms like “trade surplus,” “trade balance,” and “trade deficit.”