BUSINESS & ECONOMICS

How International Trade Effects the Economy

A trade deficit isn't by itself a sign of economic weakness, and trade surpluses don't necessarily lead to increases in domestic manufacturing

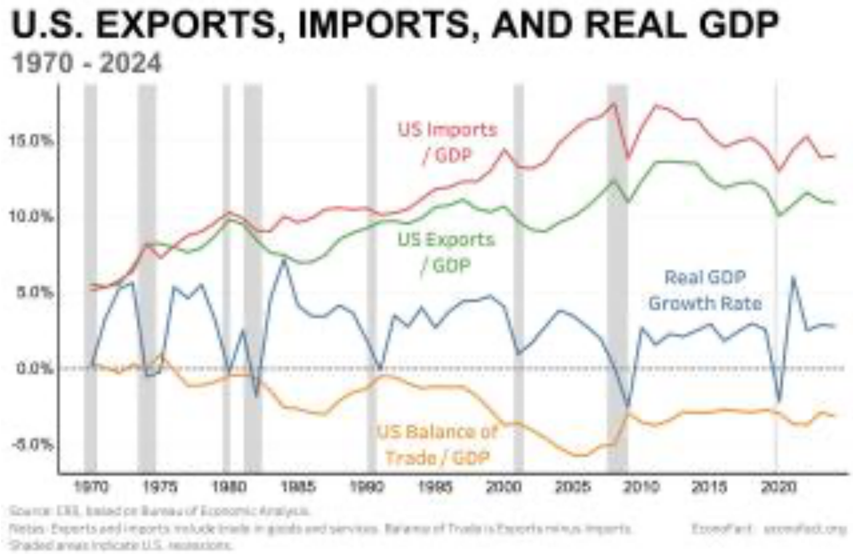
"It is sometimes missed that international trade involves services as well as goods—the administration's formula for tariffs is based on imbalances in only goods trade and does not take into account trade in services," write Michael Klein. Photo: Shutterstock

By Michael Klein | April 23, 2025

President Trump and members of his administration claim that international trade is rife with unfair dealing. As a sign of this unfairness they point to the fact that the U.S. buys more goods from many countries than these individual countries purchase from the United States, arguing that such bilateral trade deficits mean that the United States is being "ripped off".

They claim that the country's overall trade deficit—the sum of the U.S. trade balance with all countries—represents a macroeconomic weakness: Trump's executive order declaring a national emergency due to trade begins by stating "large and persistent annual U.S. goods trade deficits, constitute an unusual and extraordinary threat to the national security and economy of the United States."
What can bilateral trade deficits and the country's overall trade deficit tell us about our trading relations and the health of the U.S. economy?

Over the past 50 years, international trade has become an increasingly important feature of the U.S. economy. The U.S. has been running a trade deficit—that is that the total value of imports to the country has exceeded the value of U.S. exports—every year since 1975. However, this does not represent a decline in the country's exports. On the contrary, both exports and imports have more than doubled since the beginning of this period (see chart).



This reflects the greater integration of the United States in the world economy, something that has been happening worldwide—world trade relative to world GDP has increased from 26% in 1970 to 63% in 2022.

Moreover, there is a high correlation (greater than 90%) between exports and imports—typically when U.S. exports to the rest of the world are declining, U.S. imports of foreign goods tend to decline as well. This is especially the case in crisis years like 2008–2009 and 2020. The global financial and economic crisis and the onset of COVID saw both a contraction of the United States economy (and other economies) and of world trade.

It is normal for a country to have a bilateral deficit with some of its trading partners and bilateral trade surpluses with others. The economist Robert Solow illustrated the irrelevance of bilateral trade deficits by noting that he had "a chronic trade deficit with my barber who doesn't buy a damned thing from me." But this does not mean Solow's barber was taking advantage of him. Solow simultaneously had a persistent trade surplus with his students who benefited from learning from a Nobel laureate.

> "A nation that has a persistent trade deficit is one that is consistently spending more than it earns."
>
> **Michael Klein**

There is a similar logic for a country's trade patterns. Businesses will export those goods and services that can be produced more cheaply or of a higher quality than those of foreign competitors.

The United States is a major exporter of manufactures (including airplanes and other transportation equipment); fuels and mining products; and many agricultural commodities, among other products. In the same vein, Americans purchase most of their clothes and footwear from foreign suppliers able to produce them at a lower cost.

It is sometimes missed that international trade involves services as well as goods—the administration's formula for tariffs is based on imbalances in only goods trade and does not take into account trade in services.

The United States is the world's leading exporter in services, running a trade surplus in services that reflects its comparative advantage in areas like education, entertainment, and finance. In 2024, the United States ran a trade surplus in services of $295 billion (and a trade deficit in goods of $1,213 billion).

Bilateral trade statistics can be misleading. Exports are recorded as going to the country that initially receives goods, not their final destination. For this reason, the United States has large recorded trade surpluses with the Netherlands, since its ports receive goods from the United States that are then transported to other countries.
The global integration of supply chains—where the components for a final product are sourced from many countries—also muddies measures of bilateral trade. Trade statistics record the wholesale price of a final good from a country as the value of its export without taking into account inputs that come from other countries.

For example, the full value of an iPhone assembled in China is recorded as an import from China even though its design, software development, project management, and other elements of its production are supported by high-wage jobs in the United States, and many other physical components are made in countries other than China.

In a world with extensive international supply chains, this can lead to large mis-assignments of the source of exports. The appropriate assignment of the value added of an import to each country that contributes to its production is difficult to untangle.

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But research has found that, for example, in 2004 the United States' bilateral trade deficit with China based on the value added by Chinese companies to its exports to the United States was 40% smaller than the reported bilateral trade deficit that was based on the gross value of goods.

The mirror image of this is that the bilateral trade deficit with Japan based on value added was about 40% larger than the recorded trade deficit. These differences reflect that China was a net importer of inputs to production of goods that saw their way to the United States, while Japan was a net exporter of these inputs.

This type of problem with bilateral trade statistics does not follow through to overall aggregate trade statistics, since everything must come from somewhere, so overestimates and underestimates cancel out.

An aggregate trade deficit is not by itself evidence of economic weakness. National income, as measured by Gross Domestic Product (GDP), measures the sum of what households consume, investment by firms, government spending, and net exports (exports minus imports). Although imports figure negatively in this relationship, this does not literally mean that imports subtract from GDP.

The components of GDP are all interrelated and are driven by other, underlying factors. There are episodes when stronger GDP growth is associated with increasing trade deficits. For example, during the Reagan boom of 1981–1985, tax cuts and increased defense spending stimulated GDP growth. Stronger growth in national income led to higher consumption and greater investment, including consumption and investment of imports.

At the same time, these policies led to higher interest rates in the United States, which attracted foreign capital inflows that strengthened the dollar, making imports cheaper and exports more expensive. The dollar appreciation further contributed to the increasing trade deficit.

Alternatively, there are scenarios in which stronger GDP growth could be accompanied by a shrinking trade deficit. For instance, faster growth abroad draws in exports from the United States, which shrinks the American trade deficit while driving a higher rate of U.S. GDP growth.

These two examples illustrate that there is no consistent theoretical relationship between the trade deficit and GDP growth. In fact, the correlation between net exports relative to GDP and GDP growth over the last half century is essentially zero (-0.6%).

Over the long term, trade deficits that are persistent reflect underlying economic conditions that contribute to higher levels of imports over exports. A nation that has a persistent trade deficit is one that is consistently spending more than it earns. Much like a household that buys more than it earns, a nation will need to borrow from abroad to fund its higher spending. Persistent trade deficits can lead to a larger or more productive economy over the long-term, if spending is for productive investment.

Manufacturing employment has decreased in advanced economies over the past two decades regardless of whether they have had trade deficits or trade surpluses. The Trump administration has argued that trade deficits are the source of manufacturing employment decline. Manufacturing employment as a fraction of total employment has been declining in the United States, a country that has run persistent trade deficits. But manufacturing employment as a fraction of total employment has been declining across all advanced economies.

“There is no systematic link between bigger trade deficits and slower economic growth.”

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For example, Germany has run persistent trade surpluses over the past three decades, consistently about 4 or 5 percent of its GDP while it saw a decline in production industry employment by over one third. Part of the reason for this is automation—fewer workers are—required to produce any given level of manufacturing output.

Which is not to say that trade has not had a disproportionately negative effect on some manufacturing-dependent communities. There is evidence that the rapid and massive rise in trade with China harmed some local economies. These effects are strongest in places where an industry has already been phasing out, where wages are relatively high, or where education levels are low.

What This Means

While some countries may engage at times in protectionist measures or provide subsidies to specific industries that result in advantages to some of their domestic industries, bilateral trade deficits are not of themselves evidence that this is the case and, in fact, provide an increasingly unreliable picture in the face of globally integrated production.

Workers whose companies face greater international competition can be hurt by trade, of course, and there are strong arguments for appropriate safety net policies for them, as there are for those hurt by economic dislocations due to technological change or other disruptive factors.

But the fact that trade has become a bigger share of the economy, both for the United States and for the world as a whole, means that disruptions to trade and global supply chains can have a consequential economic impact.

For the economy as a whole, both trade deficits and overall growth arise from other, underlying causes and there is no systematic link between bigger trade deficits and slower economic growth.

This article was originally published on Econofact*, a non-partisan publication designed to bring key facts and incisive analysis to the national debate on economic and social policies.* EconoFact *is overseen by Michael Klein, a professor of international economics at The Fletcher School.*