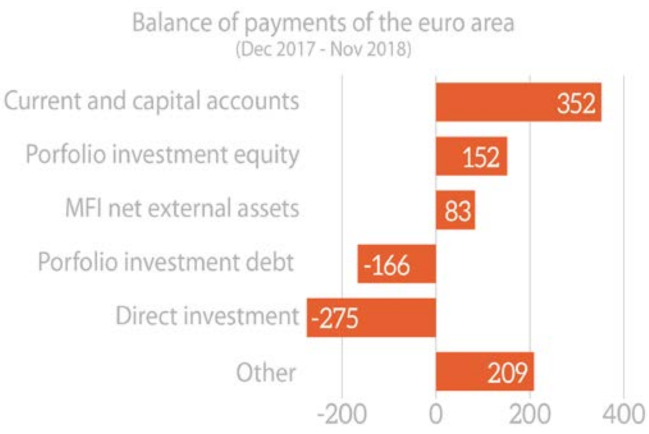
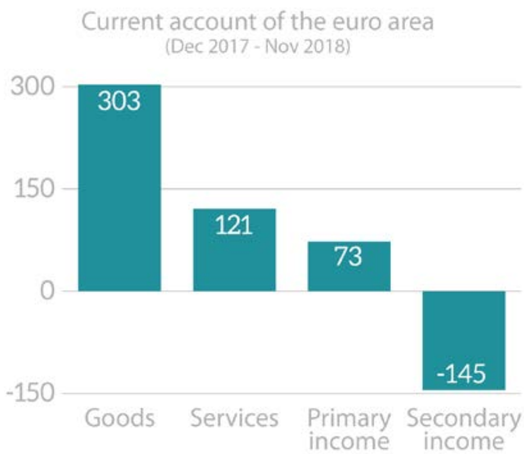
Understanding trade balances

Trade policy discourse on both sides of the Atlantic has recently focused on trade deficits and surpluses. In the United States (US), President Donald Trump has routinely referred to the US trade deficit as a central indicator of the country's economic woes and made its reduction a key objective of US trade policy. In Europe, the world's largest trade surplus, run by Germany, has come under scrutiny. However, focusing on trade balances of exports and imports can be misleading in the trade policy context. Trade balances need to be considered as an integral part of a larger whole, the balance of payments of an economy. The imposition of specific trade policy measures, such as unilateral tariffs, cannot be expected to improve a trade balance significantly.

Balance of payments

The balance of payments (BoP) shows all transactions in an economy and is composed of three parts: the current account, the capital account, and the financial account (which accounts for the ownership of assets). Within the BoP, the current account consists of international transactions in goods and services (i.e. imports and exports), as well as primary and secondary income (e.g. remittances or aid). The term trade balance, that is, exports minus imports, is sometimes used interchangeably with the current account balance. Another confusion arises as the term 'trade balance' is defined broadly to include trade in goods *and* services, but is occasionally used narrowly to indicate trade in goods. The trade balance often makes up the largest part of the current account, which is nonetheless just one element of the BoP. Therefore, it is important to pay attention to the underlying definition in a policymaking context as well as consider the full composition and interplay of the current and capital accounts, which together represent the degree of an economy's openness with the rest of the world.





Data source: European Central Bank.

Key considerations

Impact on GDP

Running a trade deficit is often associated with a variety of negative economic impacts, while surpluses are associated with a variety of positive economic impacts. These generalisations are misleading in macroeconomic terms. A country's trade balance does not have an inevitable effect on the economy's gross domestic product (GDP). In simplified terms, the GDP includes as one of its components net exports, and a trade surplus could imply an increase in GDP. In essence, trade surplus countries are lending to other countries so that the latter can finance their deficits while deficit countries are borrowing from the rest. However, high imports can reflect higher public or private consumption or higher investment in an economy. Whether a surplus is good or bad also depends on how the country spends the borrowed money.

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PE 633.187 – February 2019

One of the reasons why the US is running a trade deficit with most of its trading partners could be high consumer demand, low levels of (household) savings, and low risk on investments. In the US the trade deficit is associated with domestic growth. However, if an economy does not invest and spend enough domestically, economic growth could be negatively affected. Germany, for example, has come under criticism for its economic policy, which favours exporting companies and the reinvestment of their capital gains abroad rather than domestically. Yet, if lending can generate higher returns than domestic investment, it could even be beneficial for a surplus country.

Bilateral imbalances

The preoccupation with trade balances relies on a view of trade as a zero sum game premised on the idea that one country's exports are another country's imports, or that one country's surplus is another country's deficit. However, a bilateral trade balance between two countries is an inappropriate expression of the effectiveness of a country's trade policy (e.g. in terms of market access and trade agreements) because countries specialise their production according to their comparative advantage. Overall, both sides stand to gain from trade when goods are produced where costs are lower.

Trade in goods

It is important to consider that trade takes place in a complex web of trade and investment relationships that goes beyond simple trade in goods. Much of today's trade is organised in global value chains. The measure of trade balance does not capture the added value for the economy that is derived from imports of intermediate goods and components to manufacture export goods. In addition, for developed economies such as the EU, it is critical to consider trade in services and trade in intangibles, such as intellectual properties or know-how. Accounting for these factors, trade balance can look markedly different. For instance, the US has an overall surplus with the world in services.

Employment

Trade liberalisation can lead to job losses (e.g. due to relocation or increased competition) as well as job gains (e.g. in exporting companies). However, the idea that trade deficits cost jobs is based on several simplifications: one idea is to look at the employment content of exports and imports and derive the number of jobs lost or created; another is the idea that competition from cheaper imports pushes out domestic producers and therefore affects employment. However, there is no clear link between the US deficit and its employment rate, and a limited connection between the US steel and aluminium tariffs and jobs created in the sector. In recent years, despite running a persistent trade deficit, overall the US economy has had close to full employment. Furthermore, the US (deficit) and Germany (surplus) have seen similar declines in manufacturing employment over recent decades. Finally, to understand the consequences of trade balances for employment it is important to disaggregate by sector. Technological development and the transition to the service economy may adversely affect jobs in manufacturing or agriculture, but are also creating new jobs elsewhere in the economy (e.g. in engineering and other services sectors).

Policy implications

Trade imbalances can arguably pose threats to the domestic and global economy. Countries that run extensive trade deficits could rely on external capital flows too heavily and be vulnerable to sudden stops, making the prospect of financial crises more likely. Excessive surpluses, on the other hand, can decrease global demand. However, the potential of tariffs and trade agreements to correct trade imbalances has been overstated. The EU has a common trade policy but its Member States run differing trade balances. According to German government analysis, the German surplus is due mainly to the dynamics of demand and supply that are difficult for policymakers to control. Apart from exports, underlying factors accounting for the surplus include relatively low wages, returns on foreign investments, and an undervalued currency since the trade balance is connected with capital inflows and outflows. The US unilateral measures, put in place partially to fight the trade deficit, have not rectified the situation. After imposing tariffs on imports from China, the US recorded the widest trade deficit in a decade. This was partly due to retaliatory tariffs, but also due to currency fluctuation and an expansionary US fiscal policy. In the same vein, measures such as potential car tariffs would not solve the US trade deficit.