FREE TRADE FACTS

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Trade Deficits: A Short Primer

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Introduction

A country runs a trade deficit whenever it imports, during some period (e.g., a calendar year), a greater monetary value of goods and services than it exports during that period.

The trade deficit is the difference between the value of imports and exports whenever imports exceed exports. (If the value of imports is less than that of exports, the country runs, in that period, a trade surplus.) Although strict devotion to technical precision would demand that I write here about the "current account deficit," the difference in the United States between the trade deficit and the more general current account deficit is sufficiently minor that I will stick with the common term *trade deficit*.

By most measures, the United States has run an unbroken string of annual trade deficits starting in 1976.[1] So far, 2025 is on track to be yet another of those years, which will make it the 50th consecutive year in which the United States has run an annual trade deficit. These deficits are believed by many people across the ideological spectrum to be evidence of faulty economic policy here at home or of unfair trade practices abroad. These deficits are also thought to create further economic problems in the United States. If these beliefs are correct, it follows that economic policy should be changed. And the specific change that is most frequently suggested is raising tariffs on imports. The belief here is that higher tariffs, by discouraging the importation of goods and services, will decrease—and, perhaps, eliminate altogether—the excess of imports over exports.

These three commonplace beliefs about trade deficits, however, are mistaken. First, US trade deficits are not, in practice, evidence of faulty economic policy at home or of unfair trade practices abroad. Second, these deficits do not cause economic problems for Americans. Third, raising tariffs on imports is not an effective means of reducing these deficits. Therefore, we should consider each of these three points in turn.

1 "U.S. Trade Balance," Macrotrends, accessed May 26, 2025, https://www.macrotrends.net/global-metrics/countries/usa/united-states/trade-balance-deficit.

What Causes US Trade Deficits?

US trade deficits result from foreigners being relatively more eager and able to invest in America than Americans are to invest abroad.

Suppose that this year Americans buy $3 trillion worth of goods and services from foreigners, but foreigners buy only $2 trillion worth of goods and services from Americans. America then has a trade deficit of $1 trillion. Only $2 trillion of the $3 trillion that Americans sent abroad as payment for US imports returns to America as demand for US exports. What do foreigners do with the remaining $1 trillion? The answer is that foreigners are just like you: If you earn $100,000 this year and want to invest $10,000, you will spend only $90,000 on goods and services in order to have the $10,000 you need to fulfill your investment desires. Likewise, if foreigners want to invest in America, they cannot spend all their dollars buying American goods and services; like you, they must spend in America less than is maximally possible in order to have the dollars they need to invest in America.

And so, just as you return $10,000 to the economy by investing it rather than by spending it, that $1 trillion that foreigners do not spend on American exports is nevertheless returned to the US economy by being invested here.

Significantly, because no one invests in projects, enterprises, or organizations that are believed to have dim economic futures, global investors' continued willingness to invest in America is powerful evidence that these investors have a positive view of the US economy's future, at least relative to the futures of many other countries.

And, indeed, the US economy, although far from perfect, has much going for it. America is home to hundreds of millions of some of the world's wealthiest consumers. More importantly, compared to most other countries, America is especially welcoming to entrepreneurship and economic dynamism; its financial markets are sophisticated, fluid, and deep; its labor market is competitive and populated with large numbers of highly skilled workers; it is rich in capital goods; its tax rates are not crushing; its government is stable; and property and contract rights are secure.

In our example, these features of the American economy attract $1 trillion of investment funds from around the world, with one result being a $1 trillion US trade deficit. But it is clearly an error to interpret this trade deficit as evidence either of American economic decline or of unfair or nefarious practices by foreigners. Instead, this trade deficit is evidence of American economic vigor and of foreigners' appropriate—and, as we shall see, economically helpful—responses to that vigor.

The widespread failure to grasp this reality is due in no small part to the term *trade deficit*, which conjures an image of imbalance and loss. This image, however, is false. Because a healthy economy features not only *buying and selling* but also *saving and investment*, international commercial accounting is appropriately designed to measure both categories of economic activity (consumption and investment). Thus, we have for each and every country two accounts: the current account, on which are recorded imports and exports, and its sister account, the "capital account," on which are recorded inflows and outflows of capital. These two accounts are meant to be considered jointly with each other. Only by mistakenly supposing that international commerce affects only one or the other of these two accounts does a country's trade appear to be unbalanced.

The current account is exactly mirrored by the capital account. If this year the United States runs a $1 trillion trade deficit, it also *necessarily* runs a $1 trillion capital account *surplus*. Adding the value of the trade deficit (which is negative) to that of the capital account surplus (which is positive) always yields a value of $0—meaning there is no imbalance. (Indeed, "capital account surplus" serves well as a synonym for "trade deficit.") It follows that if America's relative attractiveness as a place to invest increases, the

US capital account surplus and, along with it, the US trade deficit will increase by the exact same amount. It also follows that one sure way to decrease the US trade deficit is to adopt policies that will slow—or, more effective yet, reverse—US economic growth. The more economically destructive economic policies are, the more the US trade deficit will shrink.

Important to note at this point is that, contrary to popular belief, when the United States runs trade deficits, Americans do not necessarily go further into debt to foreigners. Nor do Americans necessarily reduce their net asset holdings by selling assets to foreigners. Stated differently, contrary to popular belief, US trade deficits do not necessarily reduce Americans' real net worth.

If, in our example, foreigners use the $1 trillion that they do not spend on American exports to *build new factories in America*, those transactions increase the US trade deficit by $1 trillion, but there is no corresponding rise in American indebtedness. Regardless of how well or poorly these factories fare, no American is obligated by these transactions to pay anything to foreigners. The same is true if foreigners use those dollars to buy shares of stock on the New York Stock Exchange, to buy real estate in Ohio, or to hold as cash reserves. That $1 trillion becomes American debt only if foreigners lend this sum to Americans—for example, by purchasing corporate bonds. And because this net inflow of capital allows Americans to increase their own asset holdings further (e.g., the US corporations that borrow the money can put it to productive use), Americans' real net worth can increase even as the country consistently runs trade deficits.

Such an increase in net worth is what actually takes place. As of 2024, the average real net worth of the American household was more than triple what it was in the year 1975,[2] when America last ran an annual trade surplus.

Some Further Effects of Trade Deficits

Because trade deficits are net inflows of capital—and because the size of the global capital stock can (and, in the modern world, usually does) grow—US trade deficits contribute to growth and improvement of the American economy by increasing the size of the US capital stock. The BMW factory in South Carolina, for example, is a collection of modern capital goods and managerial methods that enables the Americans who work there to produce value at high rates. And BMW's competition for workers obliges it to pay wages that reflect that high productivity as it also obliges other US producers both to improve the productivity of their operations and to pay their workers wages commensurate with those workers' rising productivity.

We admire our neighbors from across the street who save, and we applaud the beneficial effects their investments have on the US economy. We should have the same attitude toward countries who save and invest in the US economy. In both cases, current consumption is delayed in order to use resources to produce capital goods (and capital services, such as worker training). Even households that save little to nothing are enriched by the resulting rise in economic productivity: productivity that pushes real wages up and the prices of consumer goods and services down. American workers today produce, on average, 149 percent more output per hour than they produced in 1975,[3] and their real hourly compensation has kept pace.[4] Also, today, the real[5] net worth of nonfinancial US corporations is 400 percent greater than it was in 1975.[6] These outcomes owe much to the steady inflow of global capital into America.

2 Don Boudreaux, "A Note on Changes in the Real Net Worth of the Average American Household," Cafe Hayek, March 15, 2025, https://cafehayek.com/2025/03/a-note-on-the-real-net-worth-of-the-average-american-household.html.

3 "Nonfarm Business Sector: Labor Productivity (Output per Hour) for All Workers," Federal Reserve Bank of St. Louis, updated June 5, 2025, https://fred.stlouisfed.org/series/OPHNFB.

4 Scott Winship, *Understanding Trends in Worker Pay over the Past 50 Years* (American Enterprise Institute, May 2024), https://www.aei.org/wp-content/uploads/2024/05/Understanding-Trends-in-Worker-Pay.pdf.

5 "Convert Current to Real US Dollars," Areppim, updated July 8, 2025, https://stats.areppim.com/calc/calc_usdlrxdeflator.php.

6 "Nonfinancial Corporate Business: Net Worth, Level," Federal Reserve Bank of St. Louis, updated June 12, 2025, https://fred.stlouisfed.org/series/TNWMVBSNNCB.

Tariffs and Trade Deficits

Even if, contrary to fact, US trade deficits were a phenomenon that policymakers needed to try to eliminate (or at least try to reduce), protective tariffs are, at best, an uncertain means of doing so. Higher US tariffs result in foreigners selling fewer of their exports to Americans, thus leaving foreigners with fewer dollars. With fewer dollars, foreigners will purchase fewer American exports. So while higher tariffs diminish US imports, they also diminish US exports. (The technical term in economics for this relationship is *Lerner symmetry*.) The net effect on the US trade deficit might be zero. Going back to our previous example, higher US tariffs might reduce American imports from $3 trillion to $2 trillion, but, as a result, American exports might also fall from $2 trillion to $1 trillion—leaving the US trade deficit unchanged at $1 trillion.

Of course, foreigners who earn fewer dollars selling exports to Americans might reduce their investments in America instead of reducing their purchases of American exports. Again, referring to our previous example, it is possible that, as US tariffs cut American imports from $3 trillion to $2 trillion, foreigners will respond exclusively by ceasing to invest in the United States. In this case, the higher tariffs would indeed eliminate the US trade deficit. But the ultimate cause of this outcome would be not the tariff-induced reduction in US imports but rather a loss of confidence by global investors in the US economy. If the only policy change in the United States is higher tariffs, and if this policy change does little to dim global investors' confidence in America, it is likely that foreigners will not reduce their investments in America that much when US tariffs rise; instead, foreigners will most likely respond by buying fewer American exports.

Most economists predict that higher tariffs will indeed have little to no impact on trade deficits.

Conclusion

This paper says nothing about so-called "bilateral trade deficits"—that is, trade deficits that one country runs with another individual country (such as the US "trade deficit" with Canada). The reason is that, in a world of more than two countries, the trade "balance" between any pair of countries is economically meaningless and irrelevant. There is no more reason to expect that Americans will sell to Canadians the same amount as Canadians sell to Americans than there is to expect that you will sell to your dentist the same amount as your dentist sells to you. And while a country's trade balance with the rest of the world is not meaningless or irrelevant, it is generally misunderstood. Although scenarios are imaginable in which a country's trade deficit is evidence of domestic economic problems, the far more common case is that trade deficits, being capital account surpluses, are evidence of domestic economic strength and promise. And so it is with America's soon-to-be half-century-long run of uninterrupted annual trade deficits.

Despite its many imperfections, the US economy has, over these years, been economically dynamic and productive—and has, as a result, consistently attracted capital from around the world, which has only further strengthened America's economy.