

14.2: Reading- The Balance of Trade

Why Nations Trade

Why does the United States import automobiles, steel, digital phones, and apparel from other countries? Why don't we just make them ourselves? Why do other countries buy wheat, chemicals, machinery, and consulting services from us? Because no national economy produces all the goods and services that its people need.

- Countries are *importers* when they buy goods and services from other countries;
- When they sell products to other nations, they're *exporters*.

The monetary value of international trade is enormous. In 2014, the total value of worldwide trade in merchandise and commercial services was \$22.5 *trillion*.

How Do We Measure Trade between Nations?

To evaluate the nature and consequences of its international trade, a nation looks at two key indicators: balance of trade and balance of payments. We determine a country's **balance of trade** by subtracting the value of its imports from the value of its exports. If a country sells more products than it buys, it has a favorable balance, called a trade surplus. If it buys more than it sells, it has an unfavorable balance, or a trade deficit.

$$\text{Balance of trade} = \text{Value of exports} - \text{Value of imports}$$

For many years, the United States has had a trade deficit: we buy far more goods from the rest of the world than we sell overseas. This fact shouldn't be surprising. With high income levels, we not only consume a sizable portion of our own domestically produced goods but enthusiastically buy imported goods. Other countries, such as China and Taiwan, which manufacture primarily for export, have large trade surpluses because they sell far more goods overseas than they buy.

Managing the National Credit Card

Are trade deficits a bad thing? Not necessarily. They can be positive if a country's economy is strong enough both to keep growing and to generate the jobs and incomes that permit its citizens to buy the best the world has to offer. That was certainly the case in the United States in the 1990s. Some experts, however, are alarmed at our rapidly accelerating trade deficit. Investment guru Warren Buffet, for example, cautions that no country can continuously sustain large and burgeoning trade deficits. Why not? Because creditor nations will eventually stop taking IOUs from debtor nations, and when that happens, the national spending spree will have to cease. "Our national credit card," he warns, "allows us to charge truly breathtaking amounts. But that card's credit line is not limitless."

By the same token, trade surpluses aren't necessarily good for a nation's consumers. Japan's export-fueled economy produced high economic growth in the 1970s and 1980s. But most domestically made consumer goods were priced at artificially high levels inside Japan itself—so high, in fact, that many Japanese traveled overseas to buy the electronics and other high-quality goods on which Japanese trade was dependent. CD players and televisions were significantly cheaper in Honolulu or Los Angeles than in Tokyo. How did this situation come about? Though Japan manufactures a variety of goods, many of them are made for export. To secure shares in international markets, Japan prices its exported goods competitively. Inside Japan, because competition is limited, producers can put artificially high prices on Japanese-made goods. Due to a number of factors (high demand for a limited supply of imported goods, high shipping and distribution costs, and other costs incurred by importers in a nation that tends to protect its own industries), imported goods are also expensive.

Balance of Payments

The second key measure of the effectiveness of international trade is **balance of payments**: the difference, over a period of time, between the total flow of money coming into a country and the total flow of money going out.

$$\text{Balance of Payments} = \text{Total flow of money coming into a country} - \text{Total flow of money going out}$$

As in its balance of trade, the biggest factor in a country's balance of payments is the money that comes in and goes out as a result of imports and exports. But balance of payments includes other cash inflows and outflows, such as cash received from or paid for foreign investment, loans, tourism, military expenditures, and foreign aid. For example, if a U.S. company buys some real estate in a foreign country, that investment counts in the U.S. balance of payments, but not in its balance of trade, which measures only

import and export transactions. In the long run, having an unfavorable balance of payments can negatively affect the stability of a country's currency. Some observers are worried about the U.S. dollar, which has undergone an accelerating pattern of unfavorable balances of payments since the 1970s. For one thing, carrying negative balances has forced the United States to cover its debt by borrowing from other countries. The figure below provides a brief historical overview to illustrate the relationship between the United States' balance of trade and its balance of payments.

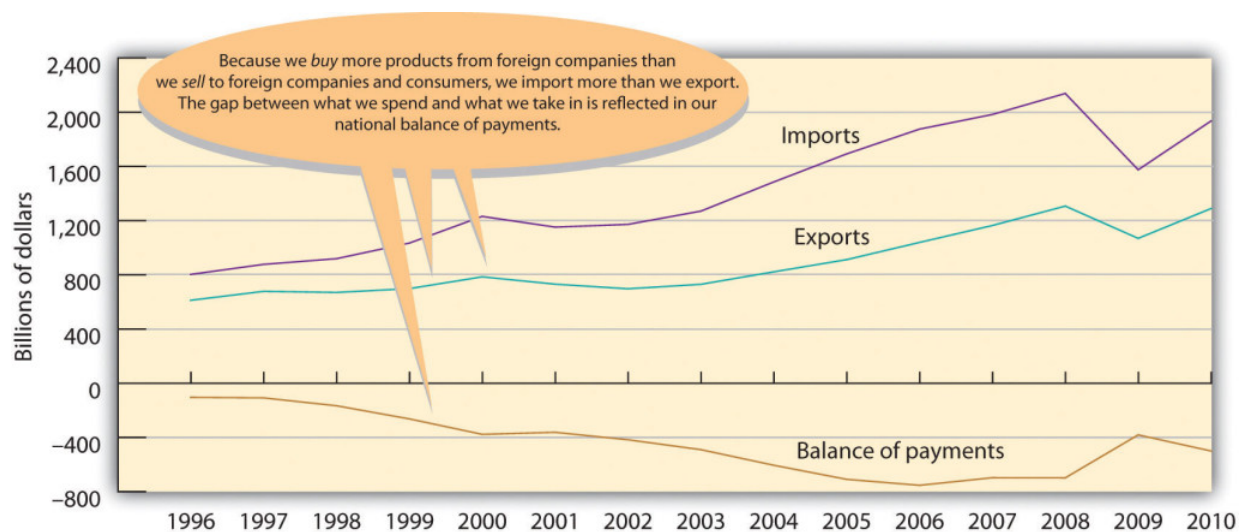


Figure 14.2.1: U.S. Imports, Exports, and Balance of Payments, 1994–2010

Note: Figures are for “goods” only, not “goods and services.” Source: U.S. Census Bureau, Foreign Trade Division.

KEY TAKEAWAYS

- Nations trade because they don't produce all the products that their inhabitants need.
 - They import those that they need but don't produce and export those that are needed elsewhere.
 - To understand why certain countries import or export certain products, you need to realize that not all countries are good at producing or are able to produce the same products.
 - The cost of labor, the availability of natural resources, and the level of know-how vary greatly around the world.
- To evaluate the impact of its international trade, a nation looks at two key indicators: balance of trade and balance of payments.
- We determine a country's **balance of trade** by subtracting the value of its imports from the value of its exports.
 - If a country sells more products than it buys, it has a favorable balance, called a **trade surplus**.
 - If it buys more than it sells, it has an unfavorable balance, or a **trade deficit**.
- The **balance of payments** is the difference, over a period of time, between the total flow coming into a country and the total flow going out.
 - As in its balance of trade, the biggest factor in a country's balance of payments is the money that comes in and goes out as a result of exports and imports.
 - But balance of payments includes other cash inflows and outflows, such as cash received from or paid for foreign investment, loans, tourism, military expenditures, and foreign aid.

Reflection Questions

- Should the U.S. buy fewer foreign goods and seek to improve its balance of trade?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

<https://assessments.lumenlearning.com/assessments/162>

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