

3.1: Overview of Trade Imbalances

Learning Objective

1. Recognize that trade deficits are not inherently bad and trade surpluses are not inherently good for a country.

There is a popular and pervasive myth about international trade. The myth, simply stated, is that trade deficits are bad and trade surpluses are good. Good or bad for whom, one might ask? Well, for the entire country.

The presence of a trade deficit, or an increase in the trade deficit in a previous month or quarter, is commonly reported as a sign of distress. Similarly, a decrease in a trade deficit, or the presence of or increase in a trade surplus, is commonly viewed as a sign of strength in an economy.

Unfortunately, these perceptions and beliefs are somewhat misguided. In general, it is simply not true that a trade deficit is a sign of a weak economy and a trade surplus is a sign of a strong economy. Merely knowing that a country has a trade deficit, or that a trade deficit is rising, is not enough information to say anything about the current or future prospects for a country—and yet that is precisely how the statistics are often reported.

The truth about trade deficits is that sometimes they are good, sometimes they are bad, but most times, they are benign (i.e., they just don't matter). There are situations in which trade deficits could be interpreted as a sign of a strong thriving economy. There are other situations in which trade deficits could be indicative of economic problems. In most situations, however, trade deficits are not large enough to warrant a positive or negative interpretation. In this case, they should be viewed without interest. These same points apply to trade surpluses as well.

The purpose of this chapter is to explain, clearly and intuitively, the circumstances in which trade imbalances should be interpreted as good and the circumstances in which they are bad. The section will show situations in which trade deficits can indeed lead to long-term harm for an economy. However, it will also show cases in which trade deficits significantly improve a country's long-term economic prospects. We will highlight cases in which trade surpluses are appropriate and a sign of strength for a country, and we will show other cases in which trade surpluses may correspond to current demise or even an eventual collapse of an economy.

Most important, one should realize after reading this chapter that merely knowing that a country has a trade deficit or surplus is not enough information to say anything substantive about the strength of a country or its economic prospects.

KEY TAKEAWAY

- Trade deficits or trade surpluses can be good, bad, or benign depending on the underlying economic circumstances.

EXERCISE

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
 - Of *good, bad, or benign*, this is what the common myth is about the nature of trade deficits.
 - Of *good, bad, or benign*, this is what the common myth is about the nature of trade surpluses.
 - Of *good, bad, benign, or all of the above*, in general, this is what trade deficits can be.
 - Of *good, bad, benign, or all of the above*, in general, this is what trade surpluses can be.
 - Of *good, bad, benign, or all of the above*, perhaps most of the time, this is what trade deficits are.
 - Of *good, bad, benign, or all of the above*, perhaps most of the time, this is what trade surpluses are.

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