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Introduction to U.S. Economy: Trade Deficit

What Is the Trade Deficit?

The trade balance measures the difference between how much the United States spends on importing foreign goods and services and how much foreigners spend on exports of U.S. goods and services. The United States has run a trade deficit every year since 1976, meaning U.S. imports have exceeded exports.

Trade Deficit Versus Current Account Deficit

The terms *trade deficit* and *current account (CA) deficit* are sometimes used interchangeably but are not the same. The CA deficit, of which the trade deficit is the largest component, is a broader measure of how much more the United States pays other countries than it receives from other countries. The CA balance, therefore, includes net income flows—investment income, pay, transfers, and remittances—in addition to the trade balance (i.e., spending on net exports). The CA deficit is an important economic concept because, by accounting identity, it is equal to U.S. net borrowing from abroad (referred to as the financial account or capital account). Hereinafter, CA and trade balances are used interchangeably unless otherwise noted.

Historical Trends

On the whole, both the trade deficit and current account deficit have grown as a share of gross domestic product (GDP) since the 1970s (see **Figure 1**). In nominal dollar terms, deficits reached an all-time high in 2024. While neither is currently as large as a share of GDP as during the early 2000s, deficits remain substantial in historical terms and as compared to other large economies. These persistent deficits have resulted in the accumulation of net foreign debt totaling roughly $26 trillion at the end of the fourth quarter of 2024. In 2024, the trade deficit was 3.1% of GDP and the CA deficit was 3.9% of GDP.

Economic Causes of the Trade Deficit

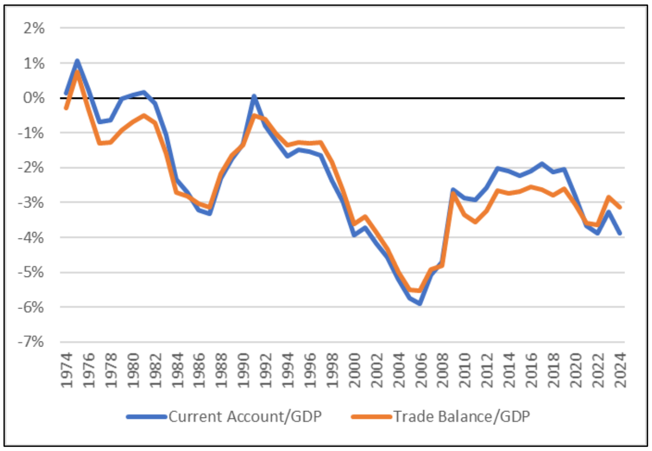
That the United States has a trade deficit is straightforward from an accounting perspective—the country is importing more than it is exporting. However, the economic concepts behind what causes the trade balance may be less apparent. The reason that the trade deficit must equal net foreign capital flows is because the only way the United States can import more than it exports is if it borrows an amount equivalent to the difference between the two (i.e., the trade deficit). By accounting identity, saving must equal investment—the money that is invested must come from somewhere. The United States is essentially investing more than it is saving and needs foreign saving to make up the difference, resulting in a trade deficit. There are two main reasons for this: (1) The United States has a relatively low national saving rate, and (2) U.S. investment opportunities are relatively attractive to foreigners.

The value of the dollar is constantly changing based on private demand. Capital and trade flows affect the dollar, because for foreigners to purchase U.S. goods or assets, they must first purchase dollars, pushing the value of the dollar up. For Americans to purchase foreign goods or assets, they must purchase foreign currency (and sell U.S. dollars), pushing the value of the dollar down.

In principle, the trade deficit could be caused by either trade flows or capital flows. In practice, the deficit tends to arise as a result of capital flows, which are an order of magnitude larger than trade flows and, therefore, largely determine the value of the dollar. For example, the value of U.S. exports and imports combined is $7.3 trillion per year, but the volume of U.S. dollars traded in foreign exchange markets is $6.6 trillion *per day* (as of April 2022). When capital flows cause the dollar to rise in value, it increases U.S. demand for imports and decreases foreign demand for U.S. exports, thus increasing the trade deficit.

Figure 1. Current Account and Trade Balance

1974-2024, as a Percentage of GDP



Source: CRS, Bureau of Economic Analysis.

Bilateral trade deficits may be reduced by changes in trade barriers or product preferences, but if the overall saving-investment imbalance does not change, a reduction in one bilateral trade deficit would be expected to be offset by an increased bilateral deficit with another country.

The Trade Deficit and the Economy

There is debate about the extent to which the trade deficit is harmful to the economy. On the one hand, concerns that the trade deficit would lead to economy-wide high unemployment or low growth have not come to fruition. On the other hand, concerns about running persistently large trade deficits could be salient in the longer term. Further, policy does not affect the trade deficit in isolation—policy options for reducing the deficit could make other economic objectives, such as low inflation or stable growth, harder to achieve. This raises the question of whether the benefits of policy changes to reduce the deficit outweigh the potential costs.

It is often assumed that the trade deficit is harmful for the economy based on the logic that imports reduce U.S. jobs in industries that compete with those imports. Although trade changes the composition of employment across industries, it does not follow that the trade deficit reduces overall employment. Less expensive imports and foreign borrowing increase employment in sectors that benefit from either, potentially offsetting any employment losses in import-competing industries. Large trade deficits have not been consistently associated with high overall U.S. unemployment. Since 2000, U.S. trade deficits have been large each year. In most of those years, unemployment has been low, including below 5% continuously since September 2021. In fact, the trade deficit has tended to be largest when the economy has been close to full employment, as strong economic performance has increased demand for imports and attracted foreign capital.

The trade deficit allows Americans to consume more goods than they produce by borrowing from abroad. Stated differently, it allows the United States to finance more investment, at lower borrowing costs, than if less foreign capital flowed to the United States. This broadly benefits U.S. consumers and U.S. borrowers, including the federal government, which is able to finance the federal debt at lower cost. If the United States imported and borrowed less, import-competing firms would be better off, but overall purchasing power would be lower.

Nevertheless, even if large trade deficits had short-term benefits, they might be unsustainable in the long run. Net foreign debt cannot grow more quickly than the economy indefinitely. Other countries have experienced economic crises after running large trade deficits. However, these countries typically differ from the United States in two notable ways. First, they were operating fixed exchange rates set by the government. Fixed exchange rates can be maintained only to the extent that a country holds enough foreign exchange reserves to meet private demand. Crises typically occur when a depletion of reserves causes the currency to collapse, which can make debt denominated in a foreign currency too expensive to service. Second, these countries were typically not borrowing in their own currencies, whereas the dollar is the world's "reserve currency," meaning that foreigners hold large amounts of U.S. assets because the dollar is seen as safe and is widely used internationally. (Reserve currency status increases foreign demand for U.S. debt, which may contribute to the trade deficit, but it also means that the United States benefits from relatively low borrowing costs.)

Options for Reducing the Trade Deficit

As discussed, ultimately national saving and investment determine the trade balance. Other macroeconomic factors can affect saving and investment and thus the size of a deficit or surplus. Because investment is an important source of economic growth, policies that would most effectively reduce the trade deficit in the long run without reducing economic efficiency are those that would increase national saving. This section discusses how different policies could affect net saving and investment and, thus, the trade deficit. It makes no judgment on whether those policies are desirable, as they would affect the overall economy as well as the trade deficit. Examples of commonly proposed policies to reduce the trade deficit include:

- **Tariffs.** Tariffs are often suggested for trade deficit reduction. By making imports more expensive, tariffs would decrease the demand for imports, resulting in a net gain in net exports and a reduction in the trade deficit. This would work with a fixed exchange rate and capital controls. However, with a floating exchange rate, economic theory predicts that imposing a tariff would not reduce the trade deficit absent other changes—even if affected countries did not impose retaliatory tariffs. That is because a tariff would reduce the demand for imports, thus reducing demand for foreign currency to buy those imports and causing the dollar to rise in value. A higher dollar would reduce demand for U.S. exports and partly reverse the lower demand for imports. Unless tariffs change saving or investment patterns, the United States would still need to borrow from abroad, causing a trade deficit. Similar arguments apply to non-tariff trade barriers and practices.

- **Federal budget deficit.** Deficit spending directly lowers national saving, thereby increasing any imbalance between national saving and investment, assuming that the deficit spending does not result in investment changes. Reducing the deficit would therefore increase saving and reduce the CA deficit (i.e., net borrowing from abroad). Since 2009, the federal deficit has been larger than the CA deficit.

- **Monetary policy.** A reduction in U.S. interest rates relative to foreign interest rates causes the dollar to depreciate, as U.S. assets are less attractive to foreign investors and demand for the dollar drops as a result. This can cause an increase in demand for U.S. net exports. Interest rates are largely under the purview of the Federal Reserve, which by statute does not take the trade deficit (but rather low inflation and full employment) into account when setting monetary policy. Lowering rates now could make it harder to achieve low inflation following recent high inflation.

- **Exchange rates.** Mechanisms to directly affect the value of the dollar are rarely used but could theoretically affect the trade deficit. Such levers include intervention in foreign exchange markets by the Federal Reserve to increase the supply of dollars or use of the Exchange Stabilization Fund (ESF) by Treasury to purchase foreign currencies, although the scale at which this could be done would likely result in only marginal changes to the trade deficit. For example, the ESF holds only $20 billion in dollar-denominated assets.

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