The Bilateral Trade Deficit
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A reader asks:

I found this article by Hal Varian, and a sentence at the end caught my attention. It says that although the Chinese only add 1% of the iPod's value, each unit exported to the US contributes about $150 to the bilateral deficit. This left me wondering: could bilateral trade numbers, namely the US deficit with China, be a fiction?

No, the bilateral trade deficit is not a fiction, but it is a rather meaningless statistic. Here is what I say about the topic in my intermediate macroeconomics textbook (this section is new in the 6th edition):

The Irrelevance of Bilateral Trade Balances

The trade balance we have been discussing measures the difference between a nation’s exports and its imports with the rest of the world. Sometimes you might hear in the media a report on a nation’s trade balance with a specific other nation. This called a bilateral trade balance. For example, the U.S. bilateral trade balance with China equals exports that the United States sells to China minus imports that the United States buys from China.

The overall trade balance is, as we have seen, inextricably linked to a nation’s saving and investment. That is not true of a bilateral trade balance. Indeed, a nation can have large trade deficits and surpluses with specific trading partners, while having balanced trade overall.

For example, suppose the world has three countries: the United States, China, and Australia. The United States sells $100 billion in machine tools to Australia, Australia sells $100 billion in wheat to China, and China sells $100 billion in toys to the United States. In this case, the United States has a bilateral trade deficit with China, China has a bilateral trade deficit with Australia, and Australia has a bilateral trade deficit with the United States. But each of the three nations has balanced trade overall, exporting and importing $100 billion in goods.

Bilateral trade deficits receive more attention in the political arena than they deserve. This is in part because international relations are conducted country to country, so politicians and diplomats are naturally drawn to statistics measuring county-to-country economic transactions. Most economists, however, believe that bilateral trade balances are not very meaningful. From a macroeconomic standpoint, it is a nation’s trade balance with all foreign nations put together that matters.

The same lesson applies to individuals as it does to nations. Your own personal trade balance is the difference between your income and your spending, and you may be concerned if these two variables are out of line. But you should not be concerned with the difference between your income and spending with a particular person or firm. Economist Robert Solow once explained the irrelevance of bilateral trade balances as follows: "I have a chronic deficit with my barber, who doesn't buy a darned thing from me.” But that doesn’t stop Mr. Solow from living within his means, or getting a haircut when he needs it.

About Me:

I am a professor of economics at Harvard University, where I teach introductory economics (ec 10) among other courses. I use this blog to keep in touch with my current and former students. Teachers and students at other schools, as well as others interested in economic issues, are welcome to use this resource.