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US Tariffs, Exorbitant Privilege, and Sustainability of the Trade Deficit

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The US trade deficit and foreign borrowing: How long can it continue?

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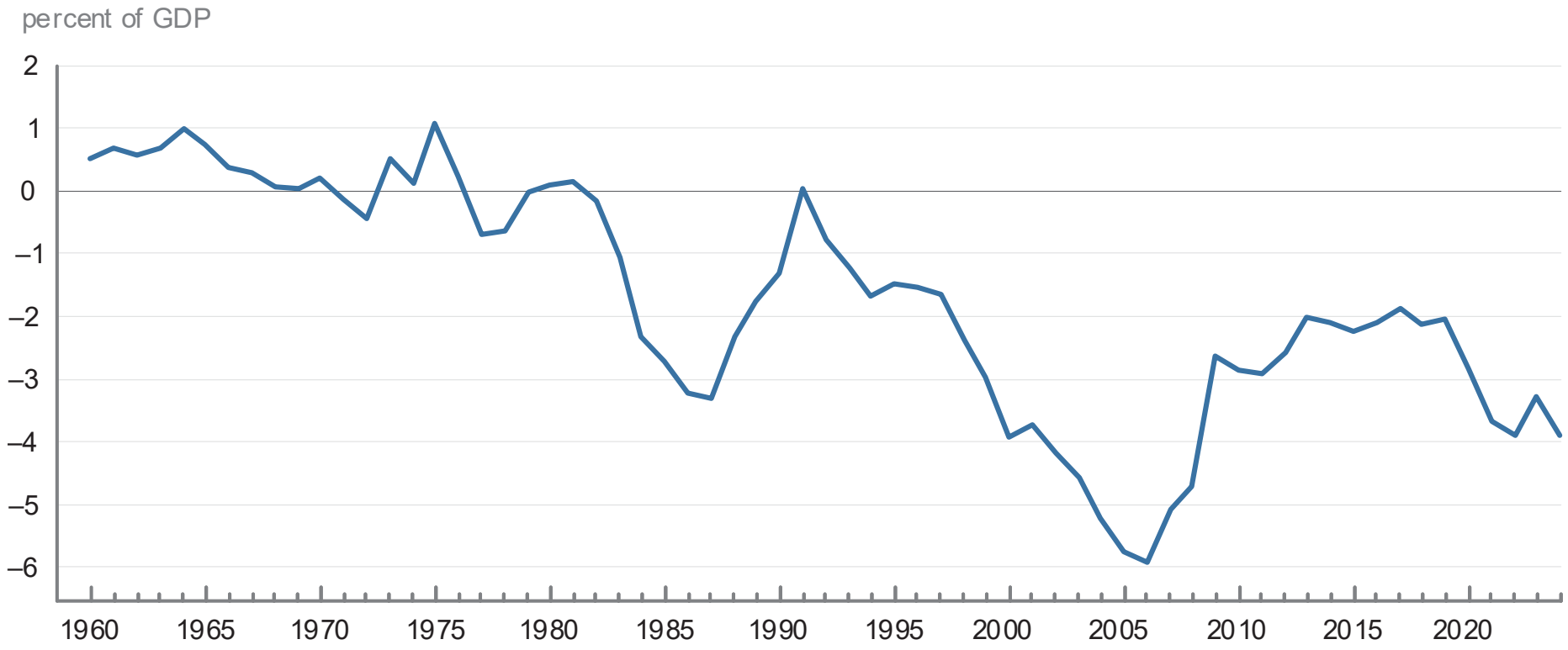
- US trade in deficit for more than 40 years.
  - 2024 net international liabilities reported at 90% of US GDP.
  - After adjusting for measurement issues, the true net liability position may be 67% of GDP.
  - This is still very large, reflecting unprecedented net borrowing as a share of World GDP.
  - Does it threaten the dollar's global role?

Figure 1

The US current account balance, 1960–2024



Sources: US BEA and authors' calculations.

- In fact, the dollar's global role is a big driver of persistent deficits.
  - US financial assets are uniquely attractive to international investors.
  - Large size, perceived safety, and creativity of US financial markets (securitization).
  - Dollar remains the pre-eminent reserve currency.
    - Massive currency manipulation in 2003-13.
    - Modest decline in dollar share in recent years.

- Trade deficit needs to shrink to stabilize net liabilities/GDP.
  - If US retains “exorbitant privilege” (lower return on liabilities than assets), deficit must shrink by 2% of GDP.
    - Requires real depreciation of 15-20%.
  - If US loses exorbitant privilege, deficit must shrink by 3.5% of GDP.
    - Requires real depreciation of 25-30%.
    - Even this depreciation is not unprecedented and might occur smoothly.

- US tariffs and the dollar.
  - Theory says a 10% tariff should push up the dollar 5%.
  - October 2024 - January 2025: dollar appreciated 5%.
  - Since late January, dollar gave up those gains.
    - Harmful and erratic policies and anti-foreigner rhetoric may be scaring off foreign investors.
    - Risk of eroding exorbitant privilege.

- How will new tariffs affect the trade deficit?
  - The size of the tariff hike is not clear. More tariffs are threatened.
  - PIIE's Chad Bown says 21 percentage points (September 25).
  - Congressional Budget Office says 18 pp (August 19).
  - Yale Budget Lab says 16 pp (October 17).
  - Customs duties in August 2025 (as share of imports) were 8 pp higher than last year.

- What is the effect of a 15 pp tariff increase on the trade deficit?
  - Assume dollar stays near its current level, roughly unchanged in broad real terms from its 3-year average.
  - Assume US grows near potential and ROW a bit less than potential (PIIE October 2025 Outlook).
  - Imports shrink about $500 billion.
  - Exports shrink $100-200 billion.
  - Trade deficit shrinks $300-400 billion, just over 1% of GDP.

- But the effect on the current account deficit may be smaller.
  - Investment income deficit likely to widen.
  - US interest rates have not declined as much as in other economies.
  - Dollar-based spreads on US Treasury yields are very low.
    - These are a key source of US exorbitant privilege.
  - So far, the net effect on investment income is small.

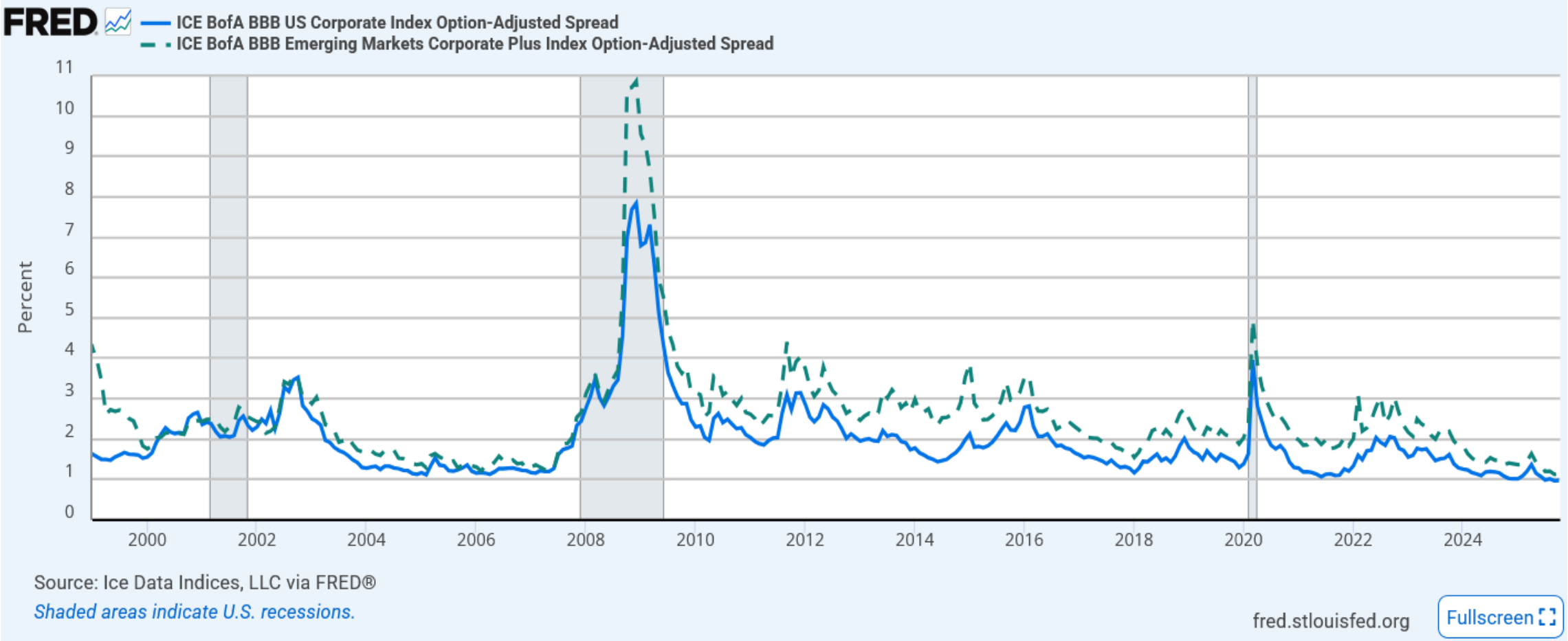

FRED
ICE BofA BBB US Corporate Index Option-Adjusted Spread
ICE BofA BBB Emerging Markets Corporate Plus Index Option-Adjusted Spread
Percent
11
10
9
8
7
6
5
4
3
2
1
0
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
2022
2024
Source: Ice Data Indices, LLC via FRED®
Shaded areas indicate U.S. recessions.
fred.stlouisfed.org
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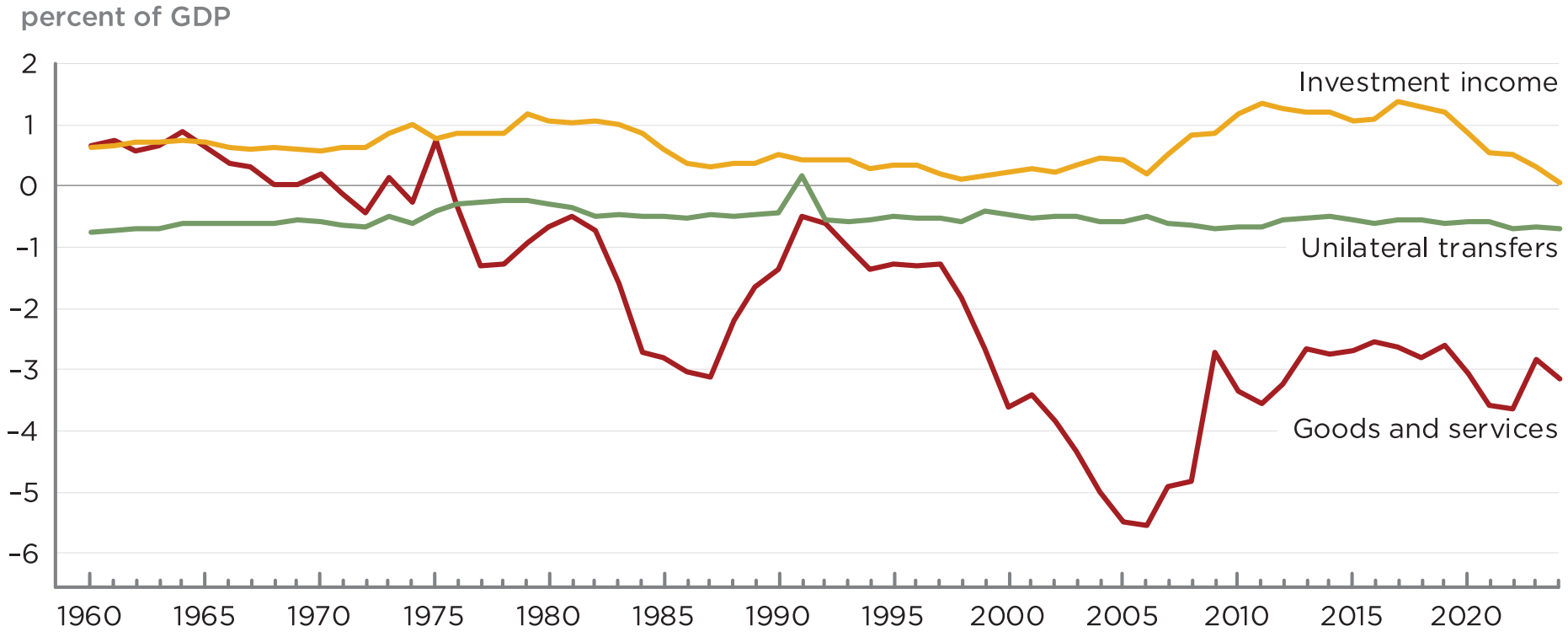
Figure 2

Main components of the US current account balance, 1960–2024

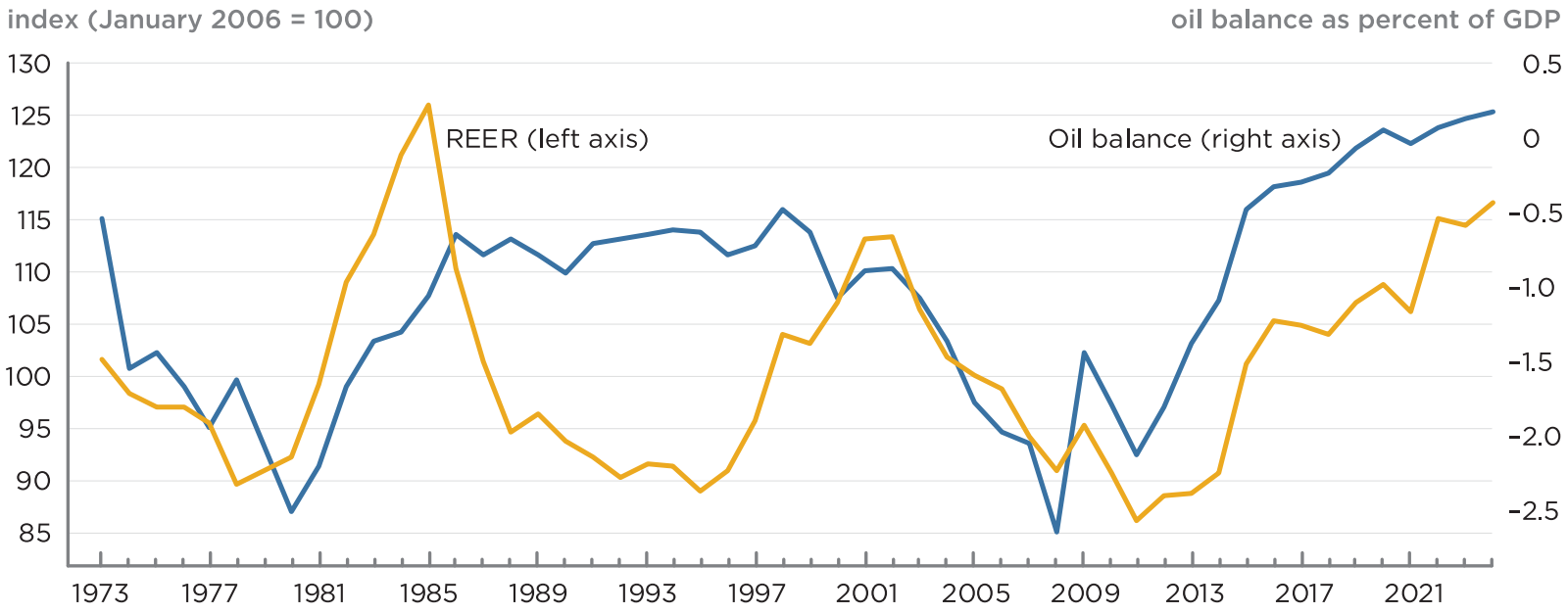


Sources: US BEA and authors' calculations.

- **Bullet list**

Figure 3

US petroleum balance and real effective exchange rate (REER), 1973–2024



Note: Before 2005 the real effective exchange rate (broad measure) is calculated using weights on goods trade rather than goods and services trade. The earlier series (now discontinued) is spliced onto the newer series in 2005. Before 1985 oil exports are assumed to be 10 percent of imports.

Sources: US Federal Reserve, US BEA, and authors' calculations.

- **The main source of exorbitant privilege is in long-term govt bonds, a large category on the liability side.**

Table 1

Rates of return on US portfolio debt (2004–24 averages, percent per year)

	Long-term bonds			Short-term paper		
	Rate of return	*Standard deviation*	*t-ratio*	*Rate of return*	*Standard deviation*	*t-ratio*
US assets	4.8	0.7	6.5	2.0	2.1	1.0
US liabilities	3.6	0.9	3.9	1.7	1.9	0.9
Government	2.8	1.0	2.8	1.7	1.9	0.9
GSEs	4.1	0.8	5.0	1.7	1.9	0.9
Private	4.5	0.7	6.7	1.8	2.1	0.9
Asset return minus liability return						
US liabilities	1.2	0.4	2.9	0.3	0.4	0.7
Government	2.0	0.6	3.5	0.3	0.6	0.5
GSEs	0.7	0.4	1.5	0.3	0.6	0.5
Private	0.3	0.3	0.8	0.2	0.7	0.3

GSE = government-sponsored enterprises

Note: Rates of return are calculated using annual interest income divided by the stock at the end of the previous year. GSE short-term interest rates are assumed to be the same as government rates, and long-term bond rates are then inferred.

Sources: US BEA and authors' calculations.

- **EP also large in reported equity returns.**
- **Adjustments tend to reduce equity EP.**
- **DI adjustment is conservative.**
- **Not clear why US P/E ratios should continue to exceed those elsewhere.**
- **EP likely to persist in long-term govt bonds, especially as US investors hold few German or Japanese bonds.**

Table 2

Rates of return on US international assets and liabilities (percent per year)

	Reported (2000–24 averages)		Adjusted (2000–24 averages)		Adjusted 2024	
	Assets	*Liabilities*	*Assets*	*Liabilities*	*Assets*	*Liabilities*
Direct investment	7.2	3.1	4.5	3.5	4.2	4.4
Portfolio equity	2.9	2.0	6.6	5.8	7.5	4.8
Long debt	5.1	4.0	5.1	4.0	4.2	3.4
Short debt	2.8	2.3	2.8	2.3	5.0	4.1
Total					5.6	4.2
Net						1.6

Note: Short-term debt is calculated as the sum of short-term portfolio debt and other investment, the latter being largely comprised of bank deposits and loans.

Sources: US BEA and authors' calculations.

- **To stabilize NIIP at -67% of GDP, CA balance must equal -2.7% of GDP.**
- **With continued EP (column 2) trade deficit must shrink 2% of GDP.**
- **With no EP and moderately high rates of return (column 6) trade deficit must shrink 3½% of GDP.**
- **A return to zero interest rates would make sustainability easier.**

Table 3

Long-run external balances under alternative rates of return with 2024 adjusted asset and liability stocks (percent of GDP)

	2024 adjusted stocks	2000–24 average rates of return	PE rate = 6	+ DI rate = 5	+ Short rate = 4	+ Long rate = 5
	(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
DI asset	35	4.5	4.5	5.0	5.0	5.0
DI liability	33	3.5	3.5	5.0	5.0	5.0
PE asset	41	6.6	6.0	6.0	6.0	6.0
PE liability	63	5.8	6.0	6.0	6.0	6.0
Long asset	11	5.1	5.1	5.1	5.1	5.0
Long liability	45	4.0	4.0	4.0	4.0	5.0
Short asset	20	2.8	2.8	2.8	4.0	4.0
Short liability	35	2.3	2.3	2.3	4.0	4.0
	2024 adjusted level	**Implied long-run balance**				
Trade balance	−2.2	−0.1	0.3	0.6	1.0	1.4
Investment income	−0.9	−2.0	−2.3	−2.6	−3.0	−3.5
CA balance	−3.9	−2.7	−2.7	−2.7	−2.7	−2.7

DI = direct investment; PE = portfolio equity; CA = current account
Note: Calculations assume a nominal growth rate of 4 percent and net unilateral transfers of 0.7 percent of GDP. *Sources:* US BEA and authors' calculations.

- **Dollar depreciation helps in 2 ways:**
  - Raises trade balance.
  - Raises NIIP/GDP.
- **US equity correction also raises NIIP/GDP.**

Table 4

Exchange rate adjustment required to stabilize NIIP/GDP (percent or percent of GDP)

	Initial conditions	2000–24 average rates of return		Equalized rates of return	
	(1)	*(2)*	*(3)*	*(4)*	*(5)*
Dollar depreciation	0	17	15	29	27
US equity correction	0	0	25	0	25
Adjusted NIIP/GDP	−67	−51	−38	−36	−23
Trade balance	−2.2	−0.3	−0.6	1.0	0.8
Net investment income	−2.0	−1.1	−0.3	−1.7	−0.9
CA balance	−4.9	−2.1	−1.5	−1.4	−0.9

NIIP = net international investment position

Note: Dollar depreciation in columns 2 through 5 is the amount required to stabilize NIIP/GDP indefinitely. Depreciation is assumed to (1) raise the value of direct investment and portfolio equity assets proportionally, and (2) raise the trade balance by 1.1 percent of GDP for a 10 percent depreciation. US equity correction is a 25 percent decline in the value of portfolio equity liabilities. All calculations assume a 4 percent nominal GDP growth rate.

Sources: US BEA and authors' calculations.