



Tariffs and the US Trade Deficit, Where Are We Headed?

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Executive Summary

- As US debt to the rest of the world has expanded to unprecedented heights, the Trump Administration has shocked the global trading system by resorting to trade policies not seen since the Great Depression.
- This paper aims to provide a basis for understanding the various forces that have driven the US trade deficit to its current depths and how the current tariff policy could influence its future course.
- We begin by reviewing the various approaches to analyzing the US external balance and documenting the actual factors that have driven it into persistent deficit in recent decades. These include most importantly an overvalued dollar reflecting the combined effects of a persistently large US budget deficit and higher saving rates abroad; China's export-led growth strategy has also contributed importantly.
- Turning to the impact of tariffs, we find that, contrary to the conventional wisdom, they could actually narrow the deficit to some extent. This is partly because foreign retaliation to aggressive US tariff policy may prove to be more hesitant and muted than in the past, at least on the part of some US trade partners. It is also because the Trump tariffs have led to dollar depreciation rather than the appreciation that normally accompanies tariffs.
- But tariff policy comes at a substantial cost in terms of increased prices and reduced output that are scheduled to show up in the months ahead and potentially to last for years.
- While there is no painless path to deficit reduction, we outline a likely more effective and less painful one. This preferred path may be politically unviable for now. But we also see popular pressure building to reverse the current tariff-focused approach as its negative economic impacts become more evident in the months ahead.

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Section 1: Introduction and Overview

The Trump Administration's dramatic shifts in trade policy are the biggest shock to the global trading system in more than half a century. The reasons put forth by the Administration for the abrupt, aggressive, and widespread implementation of tariffs include: to substantially reduce the trade deficit and move manufacturing production back home, to raise revenue, and to negotiate better trade terms abroad. Markets seem optimistic that the negotiating ploy is paramount and that tariffs will subside further as deals are reached. But that optimism may be misplaced. President Trump has consistently sung the praise of tariffs as the path to eliminating the trade deficit and reshoring manufacturing production, which he has seen as the result of unfair trading practices abroad since the 1980s.

That something needs to be done about the large and persistent US trade deficit is well understood. Prominent analysts from prior Administrations on both sides of the political spectrum, like Jared Bernstein and Robert Lighthizer, have highlighted the growing detrimental impacts of the deficit on US wealth, manufacturing output, and employment¹. But agreement ends when it comes to prescriptions for dealing with this problem. Questions about the cost and effectiveness of tariffs as the primary approach are rife.

With these thoughts in mind, our aim in this paper is to address the following eight questions:

- What have been the key drivers of the US external balance over time?
- What underlies the current persistently large trade deficit?
- Are US trade partners significantly more restrictive on trade flows than the US?
- Will tariffs succeed in reducing the deficit and moving manufacturing back to the US?
- Will other elements of Trump Administration policies facilitate this desired outcome?
- What are the potential economic costs of using tariffs to strive for this outcome?
- Are there other more effective and/or less costly ways to achieve this goal?
- What are the prospects for US tariffs going forward?

Our approach is scientific. We begin in Section 2, by outlining an analytical framework for understanding what drives the external balance, one that recognizes various different approaches. The causes of the deficit are multifaceted. They extend well beyond foreign trade practices to encompass a range of domestic and international factors that influence the supply and demand for imports and exports. Key among these factors are economic policies affecting consumer spending and business investment behavior in the US and its trading partners as well as international capital flows and currency valuations. While commercial policies play a role, we emphasize that both the trade balance and its domestic equal, the gap between saving and investment, reflect a complex interplay of these factors. The equivalence between the external balance and the domestic savings-investment gap is laid out in an Appendix.

Section 3 then provides a historical perspective, tracing the evolution of the US trade position over the past 75 years. We analyze the transition from a moderate

¹ See, for example, Jared Bernstein and Dean Baker, "We know what bad trade policy looks like, but what about good trade policy," Washington Post, March 5, 2018, and Robert Lighthizer, No Trade is Free, Harper, 2023 (especially Chapter 6). Bernstein was Chair of the Council of Economic Advisers in the Biden Administration and Lighthizer was the US Trade Representative in the first Trump Administration.



surplus position in the mid-20th century to the significant deficits that emerged in the 1980s and, subsequently, in the late 1990s to early 2000s. This period includes a precedent for near reversal of a large deficit, with some possible lessons for what to do going forward. The analysis identifies the distinct factors that contributed to deficit widening and narrowing during these periods. In doing so, it distinguishes between the "twin deficit" dynamics of the 1980s and global influences that played a greater role in more recent times, with large swings in the dollar's currency value playing an important role throughout.

Section 4 asks how the tariffs will affect the deficit and reviews evidence on that score based on historical experience. While past experience suggests limited success for tariffs in reducing deficits, we explore the possibility of different outcomes in the current context, particularly considering (a) the possibility of more muted retaliation abroad than in the past, (b) the surprising depreciation of the dollar in response to the tariffs, and (c) the possibility of elevated tariffs beginning to shift China's growth in a more consumption-led direction.

Section 5 outlines the potential costs of the tariffs in terms of their positive impacts on prices, their negative impacts on economic activity outside of import substitution, and their surprisingly negative impact on the demand for dollar assets. Here we draw in part primarily on recent research by Deutsche Bank's US Economics team.

In Section 6 we consider the prospects for the US trade deficit in light of other elements of the Trump Administration's policies, including fiscal, immigration, and foreign policies, as well as Fed policy. Fiscal policy is important because of its implications for the US saving-investment imbalance. Immigration policy has implications both for the supply of labor to yield import substitution, and for foreign demand for important US service exports in the higher education and tourism sectors. In the foreign policy arena, pressure on Europe to contribute more to funding NATO has fostered increased deficit spending on defense, thereby narrowing Europe's positive saving-investment gap.

Section 7 outlines a preferred (more effective and less costly) path to external balance in the US—mindful that any adjustment in this direction will be both painful and not immediately urgent. Like the US budget deficit, the danger in the persistent external deficit is more akin to termites eating at the woodwork than a wolf at the door. Yes the problem is serious and needs to be attended to, but it does not warrant putting the US and global economies immediately through the wringer with a plan that has high costs and relatively limited prospects for success. The measures we consider focus on both a highly desired narrowing of the very large US budget deficit and encouraging key countries abroad to reduce their high saving rates as well as ease their trade restrictions. Acceptance of the dollar depreciation that would follow is an important add-on.

Section 8 presents our conclusions, which address the eight questions raised above. To summarize, based on a review of what moves the external balance in principle and has moved it in the past in practice, today's US trade deficit reflects several factors. These include most importantly an overvalued dollar reflecting the combined effects of a persistently large US budget deficit, higher saving rates abroad, and China's export-led growth strategy. Contrary to the conventional wisdom of empirical trade research, tariffs could actually help to reduce the deficit to some extent. This is partly because foreign retaliation is likely to be somewhat more hesitant and muted than in the past, at least on the part of some US trade partners. It is also because the Trump tariffs have led to dollar depreciation rather than appreciation as is normally the case. But tariff policy comes at a substantial cost in terms of increased prices and reduced output



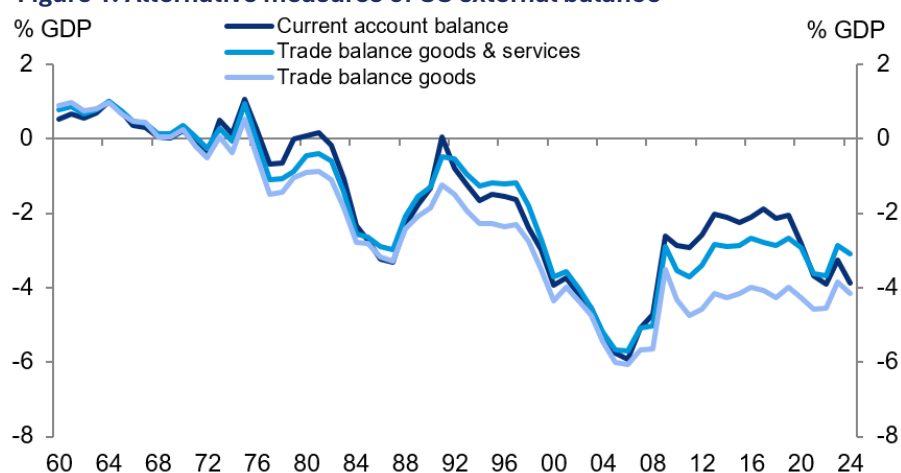
overall in the US in both the short run and the medium term. While there is no painless path to deficit reduction, we outline a preferred and less painful one. The preferred path may be politically unviable for now. But we also see popular pressure building to reverse the current tariff-focused approach as the negative economic impacts of the tariffs become more evident in the months ahead.

Section 2: What determines the US trade balance

There are a variety of approaches to understanding what drives a country's external balance, a truly multifaceted concept. One can focus on trade flows and their determining factors, on capital flows, on the gap between domestic saving and investment, and ultimately on various underlying government policies at home and abroad as the key exogenous forces. In this section we begin by defining some terms and then consider all these approaches and how they are interrelated.

Defining terms. The US trade balance is the amount by which US exports of goods and services exceed imports of goods and services; if it is positive the balance is a surplus, if negative a deficit. The Trump Administration has focused on the balance in goods only (Chart 1). We prefer to focus on the broader term in part because net exports of goods and services are the external or foreign contribution to GDP. A still broader measure of the external balance is the current account, which also includes net investment income and labor income transferred across borders. The US has tended to run a surplus on trade in services, so that the balance on goods and services has run somewhat higher than the balance on goods only. Until recently, the current account balance had run even higher because the US had tended to run a surplus on investment income flows. In what follows, we will focus on the balance on goods and services, which has tended to move roughly in line with the other two balances over time. By any of the measures in the chart, the US external balance has been substantially in deficit for decades.

Figure 1: Alternative measures of US external balance



Source: BEA, Haver Analytics, Deutsche Bank

Determinants of aggregate trade flows. US imports and exports both encompass a vast variety of goods and services that go directly into final consumption and investment, be they finished cars, office machinery, or stays at hotels. They also include intermediate goods and services as well as raw materials that go into the production of other goods. Indeed, the Bureau of Economic Analysis estimates that as much as 40% of US international trade is intra-firm trade, occurring within US and foreign-owned multinational



companies.² Despite the diverse composition of trade flows, empirical trade modelers have found that movements in aggregate imports and exports over time can be explained reasonably well by the following factors:³

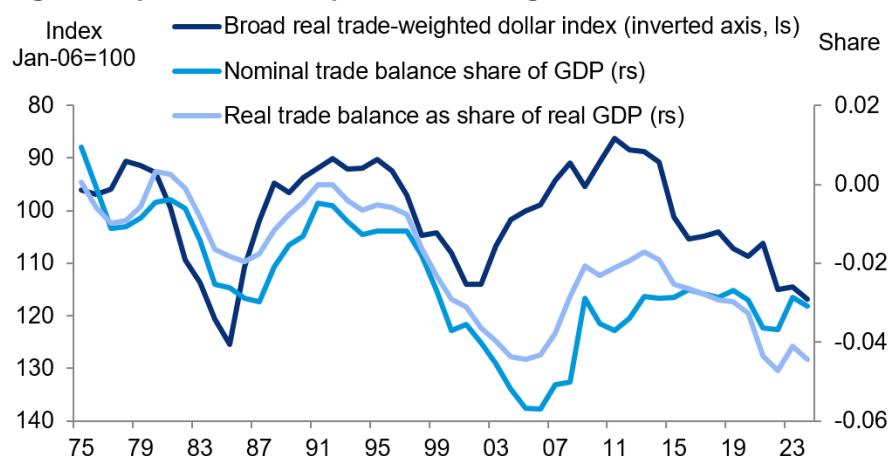
- **Real GDP** or a similar measure of aggregate domestic activity in the importing country—that means US GDP for US imports and foreign or rest-of-world GDP for US exports.
- **Relative prices.**
 - For imports, the relative prices that matter are import prices relative to domestic US prices, where import prices are determined by foreign prices and the dollar's exchange rate against foreign currencies.
 - For exports, the relative price that matters is US export prices (as determined by domestic US prices) relative to foreign domestic prices translated into dollars at the going exchange rate.
 - These relative price terms can also be adjusted for changes over time in US and foreign tariffs.
 - A good summary measure of relative prices is the Federal Reserve Board's broad real trade-weighted dollar index (Chart 2). This index shows the level of US consumer prices relative to a weighted average of foreign consumer prices translated into dollars at current nominal exchange rates. The index is not adjusted for changes in tariffs.
 - An increase in this index (on an inverted scale in the chart) means an appreciation of the dollar in real terms. Major swings in this index over time have tended to lead large swings in the US external balance (also shown in the chart) by a year or more on average.⁴ The lead or lag reflects the time it takes consumers, producers, and trade flows to adjust to major changes in exchange rates and relative prices. We will be returning to this key relationship in the next section.

² Bureau of Economic Analysis, "Activities of Multinational Enterprises, 2022," August 2024.

³ The author focused his PhD dissertation, which entailed construction of an international sector for the University of Michigan's RSQE Model of the US Economy, on testing the relative predictive performance of models of aggregated trade flows vs models that were disaggregated. The disaggregation was across both individual countries and various different commodity categories being imported or exported. He found that simple aggregated equations did significantly better in post-sample forecasting of total trade flows than forecasts based on a substantial number of disaggregated equations. Peter Hooper, "An Analysis of Aggregation Error in US Merchandise Trade Equations 1954.I-1972.IV," University of Michigan 1975. An excellent early guide to trade equation modeling is provided in E.E. Leamer and R.M. Stern, *Quantitative International Economics*, Boston: Allyn and Bacon 1970

⁴ The chart shows the trade balance (goods and services) both in nominal terms and in real terms (adjusted for changes in the prices of exports and imports). The association with the real exchange rate is stronger in real terms.

Figure 2: Cycles in relative prices lead swings in the US external balance



Source: FRB, BEA, Haver Analytics, Deutsche Bank

- **Trade or commercial policies** more generally are a third potentially key variable affecting trade flows. These include not just tariffs, but also various nontariff barriers such as quotas, licenses and permits, quality controls, exchange controls, and so on. In the past, these factors have tended to move more gradually over time than swings in real exchange rates and aggregate demand. But that has changed under the Trump Administration.

Capital flow approach. In a country's international accounts, a trade (current account) deficit is matched by an equal net inflow of capital that finances the deficit. The net capital flow reflects the balance of very large inflows and outflows of capital. These include bank-related flows and other inter- and intra-company financial transactions, direct and portfolio investments in real property and financial assets, and official capital flows. Some analysts prefer to explain or predict movements in a country's external balance by modeling capital flows. This approach has also been found to be empirically a much more challenging exercise than modeling trade flows. But it is certainly true that forces influencing capital flows, including international demand for dollar assets, can have a powerful impact on the dollar's exchange rate, which in turn is a key driver of trade flows and the trade balance.⁵

Saving-investment gap. Another approach to assessing the external balance is via its equivalence to the difference between total (private and government) domestic saving and total domestic investment. For non-economists who may be interested in the basis for this equivalence, a proof is provided in the Appendix to this paper. The external gap is also equal to the difference between investment and saving in the rest of the world. The saving-investment angle makes it easier to tie the external balance to its underlying fundamental determinants.

Fundamental determinants. The proximate determinants of aggregate trade flows, including GDP, relative prices and exchange rates, as well as saving and investment, are ultimately determined by more fundamental factors. Key among these fundamentals are macroeconomic policies—fiscal and monetary both at

⁵ Some advocates of this view, like Michael Pettis, have even advocated for imposing taxes or other restrictions on capital inflows into the US as a way to drive the dollar lower and reduce the trade deficit. See, for example, M. Pettis, "Why Keynes Opposed Free Capital Flows—and Why We Should too," *Commonplace.org*, May 12, 2025. Mindful that the external balance and the foreign exchange value of the dollar are ultimately determined by more fundamental forces, we would be as wary of such interference in capital markets as we are of the use of tariffs to try to short circuit the external imbalance in the goods market. A tax imposed on US capital inflows could well have the undesired effect of accelerating a decline in the reserve currency role of the dollar that may already be under way as discussed later in this paper.



home and abroad. Take for example a fiscal expansion at home via increased safety-net transfers to households in the face of monetary restraint will tend to increase the external deficit through several channels, by:

- Raising household income, consumption, GDP, and therefore imports, hence reducing net exports
- Raising domestic interest rates, hence the attractiveness of investing in the US, thereby boosting capital inflows and causing the dollar to appreciate and depress net exports,
- Causing households to reduce their precautionary safety-net related saving, reducing the saving-investment gap.

We turn next to how these forces have actually moved the external balance over the decades.

Section 3: Evolution of the US external balance over the past 75 years

This section provides a brief review of the history of the US external deficit and the factors that actually drove it, which should be helpful to our subsequent assessment of how things could develop going forward.

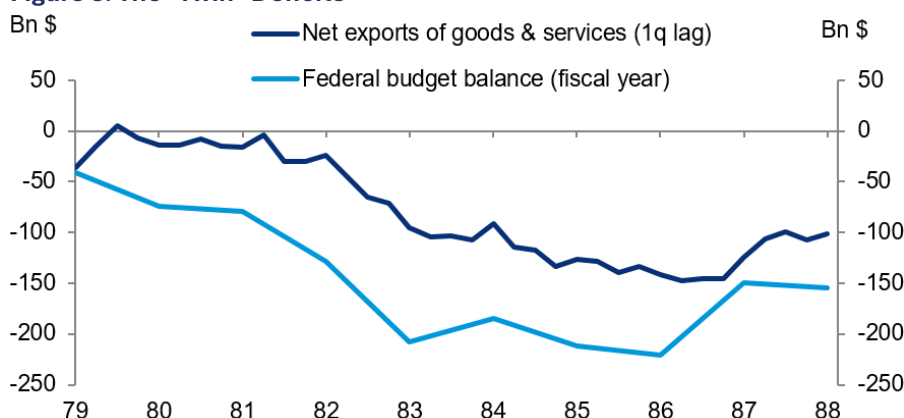
Emergence of the deficit. After running modestly in surplus for several decades in the mid-20th century, the US external balance (measured in terms of both trade in goods and services and overall current account) moved substantially into deficit during the 1980s. It then returned briefly to zero balance in 1990s only to drop substantially further into deficit in the 2000s. It has remained significantly in deficit since then (Chart 1).

What caused the initial deficit? Much has been written about the causes of the deficit in the 1980s. One comprehensive analysis that considered the various approaches described in the previous section listed the following primary factors:⁶

- US fiscal expansion, including the Reagan tax cuts and defense spending buildup. Over the first seven years of the 1980s, the trade deficit and the budget deficit both widened by about \$100 bn or at the time more than 3% of GDP. This observation gave rise to the view that these were “twin” deficits (Chart 3).

⁶ See Peter Hooper and Catherine L Mann, “[The Emergence and Persistence of the US External Imbalance 1980-87](#),” Princeton Studies in International Finance No. 65 October 1989. This study reviews much of the literature at the time and assess the causes of the deficit widening in the 1980s using the multi-level analytical framework summarized in Section 2.

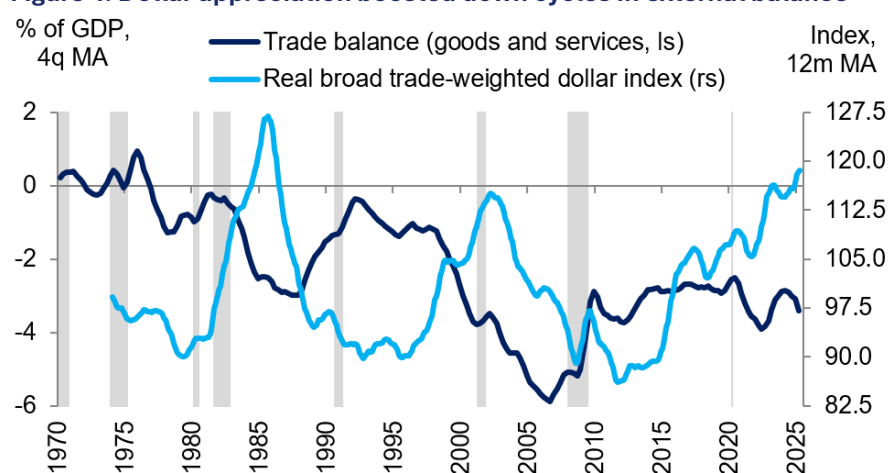
Figure 3: The "Twin" Deficits



Source: BEA, CBO, Haver Analytics, Deutsche Bank

- The fiscal expansion coincided with tight monetary policy as the Volcker Fed strove to continue bringing inflation down from high levels reached during the 1970s. This policy mix kept real interest rates substantially elevated, resulting in a massive appreciation of the dollar (Chart 4). These effects were magnified by fiscal restraint at the time in major US trading partners. The strong dollar combined with relatively strong economic growth in the US pushed the US trade deficits to then unprecedented levels.⁷

Figure 4: Dollar appreciation boosted down cycles in external balance



Source: Bureau of Economic Analysis, Federal Reserve Board, Haver Analytics, Deutsche Bank

- Trade restrictions were not found to be an important factor in the widening of the deficit during the 1980s, but one study did find that they contributed to persistence of deficit for a time following the reversal of the dollar.⁸

A precedent for deficit reversal. The large trade deficit that emerged in the 1980s was sharply reversed around the turn of the decade into the early 1990s—for a brief time to a near zero balance. This precedent for a successful, if temporary, near elimination of a large deficit was achieved without resort to protectionist measures. Indeed overall trade restrictions were easing at the time

⁷ A Brookings workshop volume in the late 1980s considered the central importance of swings in the dollar to swings in the US external balance in some detail. See Bryant, Holtham, and Hooper, [External Deficits and the Dollar: The Pit and the Pendulum](#), Brookings Institution 1988.

⁸ That was the 1989 study by Hooper and Mann referred to above.

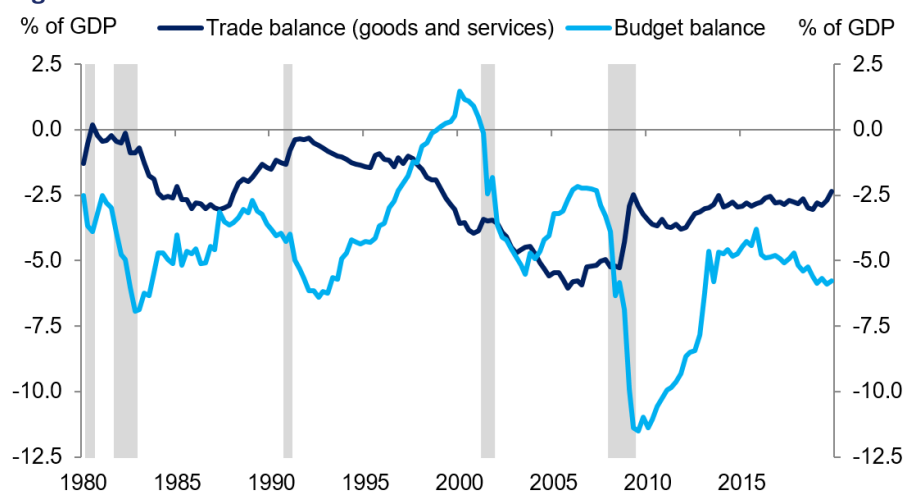


as part of the Uruguay Round multilateral trade liberalization under GATT that had been launched in 1986. The primary factors that narrowed the deficit included:

- The plunge in the dollar that occurred around and following the Plaza Accord in 1985—an agreement with several major US trading partners to engage in coordinated intervention to drive the dollar lower. Importantly, the Fed also eased monetary policy. The drop in the dollar was boosted by market perceptions that it has become substantially overvalued in view of the large external deficit that had ensued.
- The weak dollar encouraged foreign producers like Toyota and BMW to invest in production facilities in the US during this period.
- No major fiscal actions were taken at the time, but Japan did later engage in fiscal expansion, which boosted its growth significantly in the latter 1980/early 90s just as US GDP was falling into a mild recession. Cyclically weak growth in the US at a time when growth abroad remained firm did temporarily add to the narrowing of the US trade deficit.

Back into deficit. The trade deficit's flirting with near balance in 1991 was short-lived. It began to widen again as the US economy recovered from recession and growth abroad slowed. This widening accelerated sharply around the turn of the century. The dollar had reversed course and was on another extended uptrend. This time, strong dollar was not driven by US fiscal expansion, at least not initially. In fact, the Clinton Administration and Congress were at the time remarkably moving the budget balance into surplus in the latter 1990s. The twin deficit relationship was dead for the time being (Chart 5).

Figure 5: Not identical twins



Source: Haver Analytics, Bureau of Economic Analysis, Deutsche Bank

The trade deficit was responding again to a second strong dollar cycle, which occurred despite the US fiscal contraction at the time. What was driving the dollar higher, even in the face of an already sizable US external deficit, was a new flood in demand for dollar assets. Two factors were at play here: First was the attraction of high returns on dollar assets supported by a productivity and tech driven boom in US growth at a time when financial crises (Asian crisis and Russian default) were brewing abroad. Second was a surge in the supply of funds abroad looking for attractive investments. That surge was documented in research like Bernanke's 2005 speech on the global saving glut and Dooley, Folkerts-Landau, and Garber's 2003 paper on Bretton Woods II and the growing

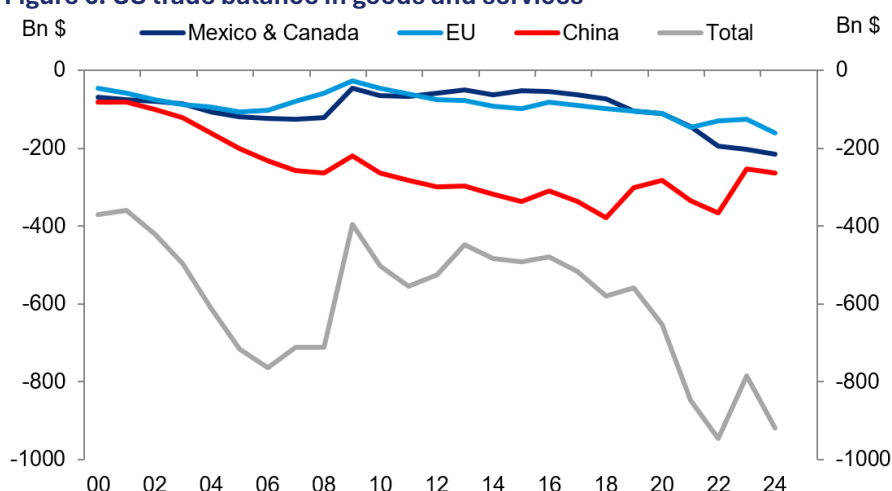


dollar reserve accumulations of China and other emerging market countries that were engaging in export-led growth.⁹

As the mid- 2000s approached, the lagged effects of the second strong dollar cycle and a substantial extra kick from China's accession to the WTO in 2001 pushed the US external deficit to double its previous record level in the 1980s.

Remaining in deficit. The dollar peaked around the 2001 recession in the wake of the bursting of the dot-com bubble. An extended downtrend ensued, through the bursting of the housing bubble and into the GFC. This depreciation helped to improve the trade imbalance from its record depths, but the deficit remained large nevertheless. It was during this period that China's export-led growth strategy and trade practices, which took full advantage of a relatively liberal world trade system, had their greatest impact on the US trade deficit. The widening of the US bilateral trade deficit with China through the 2000s dominated the two next largest bilateral US deficits—with the EU and with US NAFTA trade partners combined (Chart 6).¹⁰

Figure 6: US trade balance in goods and services



Source: Bureau of the Census, Census, Haver Analytics, Deutsche Bank

Where things stand now. The US deficit with China has narrowed since the trade war during Trump's first administration. But it has widened with other countries (most notably Mexico and Vietnam, to which some of China's export production has been moved. And the overall US deficit remains large in the neighborhood of 2.5-3.0% of GDP.

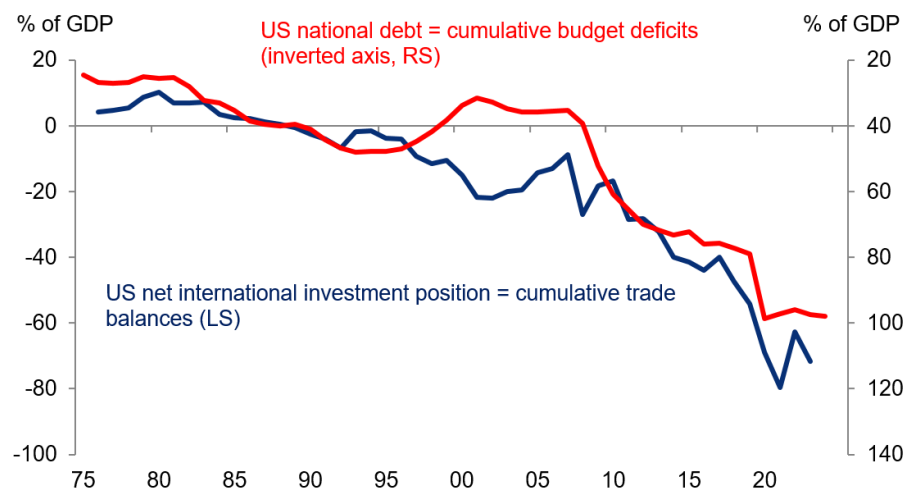
In terms of fundamental drivers, the US budget deficit has grown to levels that are clearly helping to keep the trade balance in significant deficit. While these deficits remain far from identical twins from year to year, the two have progressed remarkably closely over the longer haul. In the past two decades, both the overall US national debt and US net debt to the rest of the world have increased by a huge 50-60% of GDP (Chart 7).

⁹ See Ben S Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit" Federal Reserve Board, March 10, 2005, and Michael P Dooley, David Folkerts-Landau, and Peter M Garber, "An Essay on the Revived Bretton Woods System" (September 2003). NBER Working Paper No. wp 9971.

¹⁰ The US deficit with NAFTA was dominated by Mexico, especially more recently as its deficit with China has narrowed. The deficit with Canada has generally been much smaller.



Figure 7: US national debt moving with US net debt to the rest of the world



Source: Bureau of Economic Analysis, Haver Analytics, Deutsche Bank

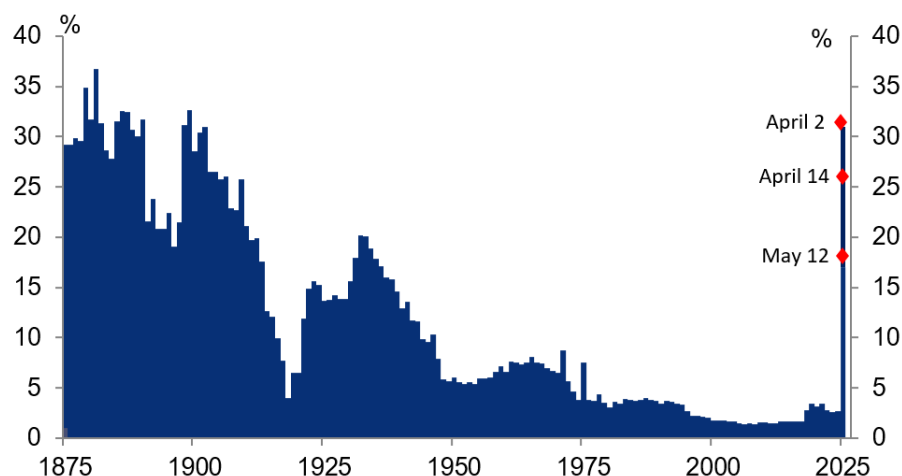
Over the past fifteen years, the persistent US external deficit has coincided with a third strong cycle of dollar appreciation, through which the US fiscal stance has operated to foster the external deficit (see Charts 2 and 4). That dollar cycle may now have begun to turn the other way again. The scaling in Chart 2 indicated that a 20-30% depreciation of the dollar could be enough eventually to narrow the deficit by about 3% of GDP. **This means that a significant reversal of the roughly 40% appreciation of the dollar in real (price-adjusted) terms against a broad set of currencies since 2010 could be sufficient to get the current deficit back to a zero balance or more.** With this in mind we turn next to various approaches to dealing with the deficit.

Section 4. How much will tariffs reduce the trade deficit?

The increases in tariffs announced by the Trump Administration have been impressive, indeed shocking (Chart 8). After having receded from over 30% more than a century ago to low-single digits in more recent decades, the trade-weighted average jumped back above 30% with the imposition of reciprocal tariffs on Liberation day (April 2). Since then, the average rate has dropped to a still lofty 18% under successive 90-day pauses in the reciprocal tariffs while trade deals are negotiated. The 18% average includes rates of 30% on China, 25% on cars and parts and steel and aluminum, and 10% on all other imports.¹¹ These tariffs have come down substantially from their peak levels for now, but they remain well above levels anticipated shortly after the presidential election. At that time, worst case scenarios had the average level rising to around 10%--a level that seemed worrisome enough.

¹¹ Note that the average level of tariffs in Chart 8 is calculated historically as tariff revenues collected divided by the value of imports at the time. But tariff revenues are not yet known for 2025, and the rates plotted for this year are based on a weighted average of current tariff rates using 2024 imports as weights. If and when import values adjust downward in response to the higher tariff rates, tariff revenues and the computed average tariff rate will decline as occurred in the wake of the Smoot Hawley tariffs, discussed further below.

Figure 8: Average US tariff rate



Source: St. Louis Fed, BEA, USITC, Macrobond, Deutsche Bank

What empirical research says A series of comprehensive empirical analyses by the IMF staff and others in recent years has reviewed the experience of more than 150 countries spanning more than six decades with both tariff increases and broader measures of trade restrictions, as well as the US experience more recently.¹² The strong finding from these studies is that the impositions of tariffs and other measures of trade restrictions have significant positive effects on domestic price levels and significant negative impacts on GDP and other measures of real economic activity at home and abroad. But in general, they have little or no significant impact on a country's trade balance. The general level of trade is reduced with both imports and exports receding. Imports are reduced by the tariffs and resulting decline in domestic activity, while exports are reduced by retaliatory measures and declines in economic activity abroad, as well by currency appreciations experienced by countries initiating tariffs.

Is this time different? One drawback to these empirical studies is that there have been few if any instances of large countries imposing tariffs increases on the scale that the US is currently imposing over the past 60 years. The earlier Smoot-Hawley Tariff Act of 1930 came closer, raising US tariff rates from an average of 38% to 60%. Both imports and exports fell by more than 60% as a result, but with little net impact on the trade balance. The collapse in trade contributed significantly to the worsening of the Great Depression and also explains why tariff revenue as a share of imports (shown in Chart 8) rose less than actual tariff rates.¹³

Less retaliation this time? A key reason why tariffs have generally had little impact on trade balances in the past is that the aggressive imposition of tariffs by one country, as the US has done, has generally induced retaliatory increases in tariffs by the trading partners affected. This time around, some major US trading partners have retaliated in kind (China and Canada) or indicated their plans to do

¹² These studies include Furceri, Hannan, Ostry, and Rose, "[Macroeconomic Consequences of Tariffs](#)," IMF Working Paper WP/19/9, 2019; Estefania-Flores, Furceri, Hannan, Ostry, and Rose, "[A Measurement of Aggregate Trade Restrictions and their Economic Effects](#)," WP/22/1, 2022; Boer and Rieth, "[The Macroeconomic Consequences of Import Tariffs and Trade Policy Uncertainty](#)," IMF Working Paper WP/24/13, 2024. Similar conclusions have been reached by various think tanks from across the political spectrum, including: Gagnon, "[Why Higher Tariffs Won't Shrink the Trade Deficit](#)," February 24, 2025, Petersen Institute; Obstfeld, "[The US Trade Deficit: Myths and Realities](#)," Brookings Papers on Economic Activity, March, 2025; Pomerleau and York, "[Understanding the Effects of Tariffs](#)," April 2025, AEI; and York, "[Separating Tariff Facts from Tariff Fictions](#)," April 2024, Cato Institute.

¹³ Doug Irwin provides an excellent analysis in his book, [Peddling Protectionism: Smoot-Hawley and the Great Depression](#), Princeton Univ. Press, 2011



so if the tariffs are not substantially negotiated away (EU and Mexico). These and other countries are also working to diversify their trade away from the US. And in some cases, active boycotts of US goods and services (tourism) have emerged (Canada in particular). But other countries may be willing to accept a “moderate” increase in US tariffs, while foregoing retaliation to avoid even larger increases. In the first “deal” negotiated with another country, the UK may have accepted a 10% tariff on all its exports to the US in exchange for no retaliation and even some modest reductions in its restrictions on imports from the US.¹⁴

Retaliation impact more muted. If retaliation does occur, its impact on the trade balance may be more muted than in the past because of the large size of the US trade deficit and because of differences in the price elasticities of imports and exports. This means greater scope for tariffs tending to reduce the deficit. With US imports running higher than exports by a large margin, the imposition of equal tariffs on both sides reduces imports more than exports, and hence the trade deficit. And if imports are more sensitive to (or “elastic” with respect to) tariffs than exports, this effect is magnified. Empirical evidence on aggregate US trade price “elasticities” augurs at least moderately in this direction.¹⁵

Scope for deals limited. We do not expect major breakthroughs on negotiated deals, partly because we assume the Trump Administration wants to raise tariffs by a minimum of 10% across the board, and partly because many key US partners did not have significantly tighter restrictions on imports than the US had before this year’s tariff actions got under way. A team of researchers at the IMF has been monitoring trade restrictions extensively across countries and intensively within countries. They have computed quantitative measures encompassing the wide range of different types of restrictions on trade flows, including tariffs, quotas, licenses and permits, health and quality controls, exchange controls, and so on. For each country, they have distilled these measures to a single numerical index of restrictiveness labeled “Measure of Aggregate Trade Restrictiveness” or “MATR.” The most recent observations show that as of 2019, trade restrictiveness was actually slightly greater in the US than in Canada, Mexico, and the UK, and slightly less so than in the EU, Japan, and Korea (Chart 9).¹⁶ Together these six countries/regions account for roughly two-thirds of total US trade. The difference was substantially greater for India and especially China. What this tells us is that the room to level the playing field by negotiating trade barriers abroad lower is constrained if the US is not going to reverse the additional tariff increases it has imposed so far this year.¹⁷

¹⁴ That deal had not as of mid-May been finally approved and would likely not be for some time to come.

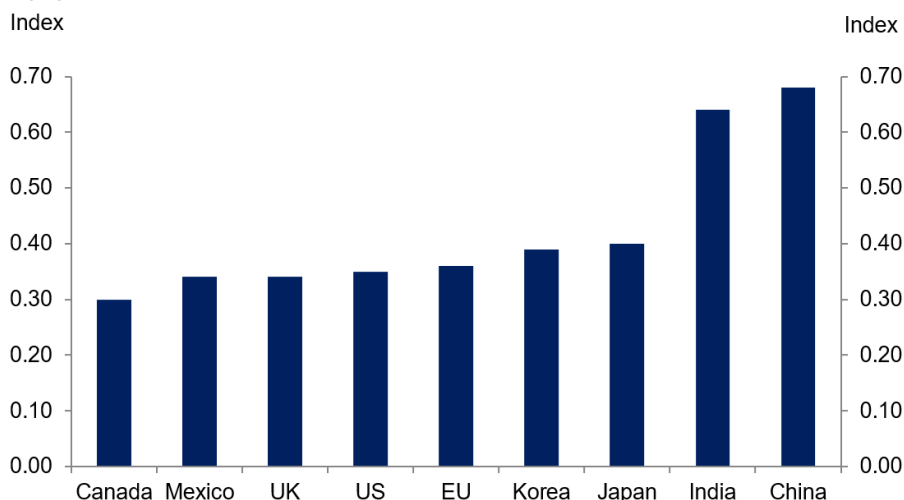
¹⁵ Comprehensive surveys have found US import price elasticities to run somewhat higher or at least equal to US export price elasticities. Two studies found the import price elasticity to be somewhat greater (more negative) than -1.0, and the export price elasticity close to -1.0: P. Hooper, K. Johnson, and J. Marquez, “[Trade Elasticities for G-7 Countries](#)”, International Finance Discussion Paper no. 609, Federal Reserve Board 1998, and Shantayanan Devarajan, Delfin S. Go, Sherman Robinson, “[Trade Elasticities in Aggregate Models Estimates for 191 Countries](#),” World Bank WP 10490, June 2023. A third study had the two elasticities about equal and both somewhat less negative than -1.0: M. Chinn, “[The Price and Income Elasticities of US Trade Flows Revisited](#),” Econobrowser Blog Post January 2025.

¹⁶ It is worth noting that most countries have their sacred cows, with very high tariffs or tariff quotas on a few sectors but much lower tariffs more generally. In Canada it is to protect their dairy industry, in Japan, rice farmers, and in the US, it is tobacco, peanuts, and sugar. The MATR factors this in.

¹⁷ The MATR refers to each country’s overall restrictiveness. Some countries may have been more or less restrictive on their imports from the US than from all countries on average. We have the sense that the EU may have been more so given relatively higher tariffs on imports of cars from the US and various restrictions on US agricultural exports. But for Canada, Mexico, Japan, Korea, and the UK, we would guess not so based on an initial perusal of data provided by the WTO’s Regional Trade Agreements Information System and the International Trade Center’s Market Access Map. More research is needed to determine relative restrictiveness on a bilateral basis more precisely.



Figure 9: IMF Monitoring of Average Trade Restrictiveness (MATR) as of 2019



Source: International Monetary Fund, Deutsche Bank

Negotiating better terms with China. China a special case not just because of the magnitude of the US bilateral trade deficit with that country. The high MATR reading for China confirms that there is ample room to negotiate better trade practices in that case. Areas that have been long-standing concerns to the US and that could be productively addressed in addition to relatively high tariffs, nontariff barriers, and other restrictions on access to China's markets include:

- Stronger protections for intellectual property.
- Prohibitions on forced technology transfer.
- Stricter limitations on subsidies for state-owned enterprises and/or their activities in global markets.
- Ensuring transparency in fair currency practices.
- Cybersecurity and protection of data privacy.
- Adherence to desired environmental and labor standards.
- Restricting the flow of fentanyl.

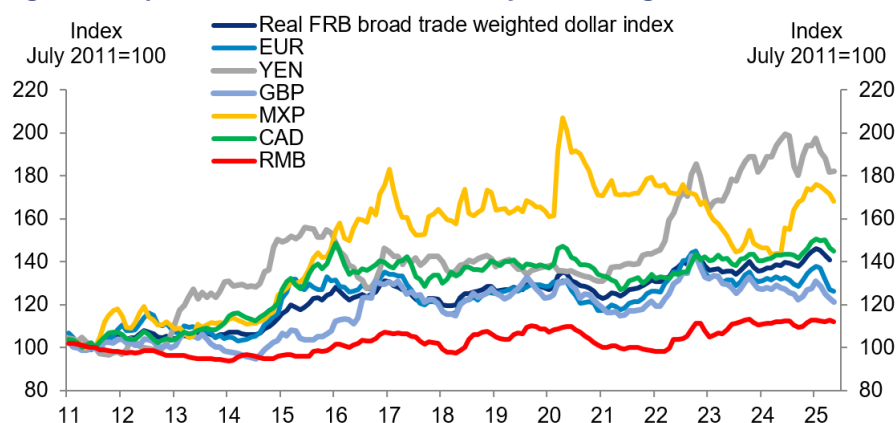
Making significant progress on many of these areas as well as tariff and nontariff barriers will be challenging. At the same time, the Trump Administration appears set on keeping tariffs on trade significantly elevated, even if far below the prohibitively high rates (for ongoing trade) announced in early April.

More fiscal stimulus in China? More broadly from a US perspective, it would be highly desirable for China to begin to transition from an export-led growth strategy that has given rise to many of the trade practices listed above to a strategy centered more on growth driven by domestic consumer spending. Some adjustment in this direction may be forced by a sudden drop in sales to the US and an inability to fully redirect sales to other areas of the world if US tariffs end up being significantly elevated. In this case, we expect China will likely engage in significant fiscal expansion.¹⁸ Some of that new stimulus would no doubt support increased consumer spending that will foster a desired transition.

¹⁸ If tariffs return to anywhere near elevated levels reached in April, fiscal stimulus measures on the order of 1-2% of GDP or more could be anticipated. See Xiong, Kojodjojo, Lai, and Ou, "[China Market Perspectives: PBOC Easing Affirms the Growth Target](#)," Deutsche Bank Research, May 7, 2025.

Dollar has not appreciated. Another feature of the current trade war that distinguishes it from many in the past is that the dollar has not appreciated as it did in the wake of the tariffs imposed under the first Trump Administration and on other similar occasions in the past.¹⁹ After appreciating about 40% from the end of the GFC (2011), the dollar reversed course early this year (Chart 10). It is now down more than 5% from its peak this January. The turn came with the indication that the Trump Administration would move much more aggressively than generally anticipated on tariff policy. The slide in the dollar continued with the announcement of major tariffs on Canada and Mexico, and the subsequent unveiling of reciprocal tariffs on Liberation day.

Figure 10: Uptrend in dollar since 2011 may be starting to turn



*Note: Bilateral exchange rates are nominal currency values of the dollar

Source: FRB, Haver Analytics, Deutsche Bank

Figure 11: Appreciation of Dollar vs other currencies

	July 2011 to Jan 2025	Jan 2025 to May 2025 (9 May)
EUR	38%	-8%
YEN	97%	-8%
GBP	31%	-7%
MXP	76%	-5%
CAD	51%	-4%
RMB	13%	-1%

Source: FRB, Haver Analytics, Deutsche Bank

Further dollar depreciation possible. The handling of the tariffs has hurt the credibility of US macro policy and caused global investors to reconsider the safe-haven value of dollar assets. As the tariffs gave rise for a time to increasing fears of US recession, US Treasury securities failed to rally as they invariably would have in the past. Instead, risk premiums on longer-term Treasuries rose. Global appetites for dollar assets receded as investors looked for opportunities to diversify their holdings into other currencies.²⁰ There has been a pause in these trends as tariff talks with China have resumed. But if the shift out of dollars continues, with the US economy hit harder by tariffs than other countries, more of the runup in the dollar over the past decade and a half will be reversed. Such a

¹⁹ The dollar also appreciated after Smoot Hawley, as home currencies often have after tariffs are initially imposed. In many cases, the appreciation is abetted by monetary restraint by central banks facing tariff-induced increases in prices.

²⁰ These and other factors set in motion by the Trump Administration to weaken the reserve currency role of the dollar are discussed in detail in an excellent recent paper by Harvey, Saravelos, and others, "[The Shift in US Leadership: Building the Euro for a New Age](#)," Deutsche Bank Research Institute, May 1 2025.



swing in currencies could move the US trade deficit toward balance, though at the cost of higher prices in the US.²¹

Summing up. Conventional wisdom and a considerable body of empirical research hold that tariffs are relatively ineffective in reducing trade deficits. This result rests in part on tariffs having in the past induced retaliation and currency appreciation, both of which hurt exports. This time may be different for several reasons:

- Retaliation, while significant on the part of the most important US trading partners, may not prove to be as widespread as in the past. Some countries may resist such action in order to avoid facing even higher US tariffs.
- That said, the scope for major concessions in trade terms with key US trade partners seems limited given how closely the overall restrictions on their imports compare with those in the US.
- Retaliation may also be less effective given the magnitude of the US trade deficit and differences in US import and export price elasticities that lean in favor of US tariffs inducing some narrowing of the trade deficit even with full retaliation.
- Tariff action could help to induce some meaningful reductions in saving rates abroad (China in particular) via fiscal expansion.
- The dollar has depreciated, not appreciated as in the past, and could decline further if confidence in US macro policymaking associated with the handling of tariff policy continues to flag. This would tend to help narrow the deficit.

These factors could add up to enough to make a meaningful dent in the US external deficit, although they would do so at a potentially significant cost to the US and global economies, the point we turn to next.

Section 5. The costs of using tariffs.

Much has been written from across the political spectrum about the detrimental side effects of using tariffs as a primary tool to strive to eliminate the trade deficit. A sampling of this literature was provided at the beginning of the previous section. The strong consensus view is that tariffs raise domestic prices, and depress economic activity by raising economic uncertainty, by reducing real incomes, and by degrading productive efficiency or productivity. By inducing retaliation, tariffs can also be a powerful depressant on world trade and therefore world economic activity. If raised to high enough levels, they can bring trade to a halt as we have witnessed briefly in US trade with China. Such an outcome could have severely negative impacts on global economic activity. The negative effects on domestic GDP may be partly offset by some gains in net exports. This is the case if retaliation abroad is muted and the dollar falls, leading and imports to fall more than exports.

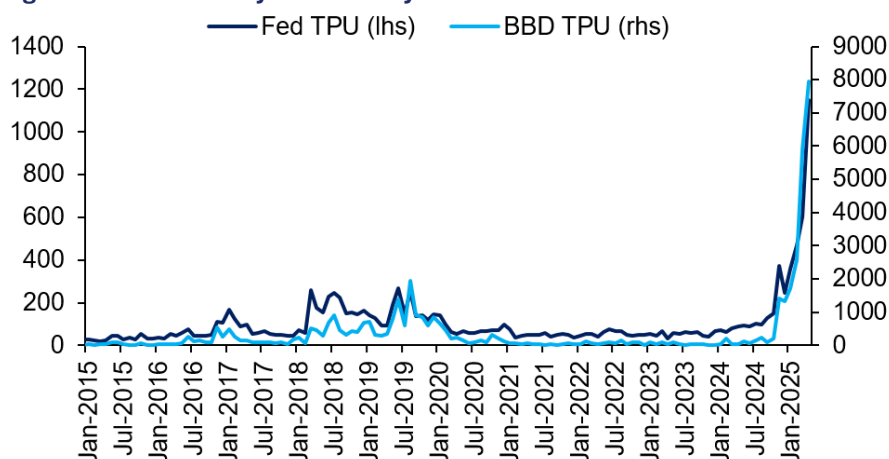
In this section, we briefly review estimates of the economic impacts of the tariffs as they stand in mid-May based on research by our Deutsche Bank colleagues. We fully recognize that this picture is subject to change as US negotiations with other countries progress and as the Administration responds to political pressures that build as a result of the likely induced economic impacts still to come.

Tariff actions announced and taken have already had impressive effects on economic data. Imports and inventories soared in the first quarter this year in anticipation of elevated tariffs. More impressive still, economic uncertainty tied

²¹ A significant decline in the dollar would raise US import and domestic prices. But unlike tariffs which invite retaliation and depress US exports, it would reduce the foreign-currency price of exports and stimulate demand for them.

to tariffs has jumped off the chart (Chart 11). A Fed staff study of the impact of trade policy uncertainty during the first Trump Administration estimated that US real GDP was depressed by nearly a full percentage point as business and households cut back on their spending in the face of this uncertainty.²² This magnitude of drag on the economy seems reasonable: GDP growth during the three pre-Covid years of the first Trump Administration was only slightly stronger than during the last four years of the Obama Administration despite the large tax cuts (the TCJA) and deregulation that boosted growth under Trump.

Figure 12: Trade Policy Uncertainty Has Soared



Source: Caldara et. al (2020), Baker, Bloom and Davis at www.PolicyUncertainty.com, Deutsche Bank

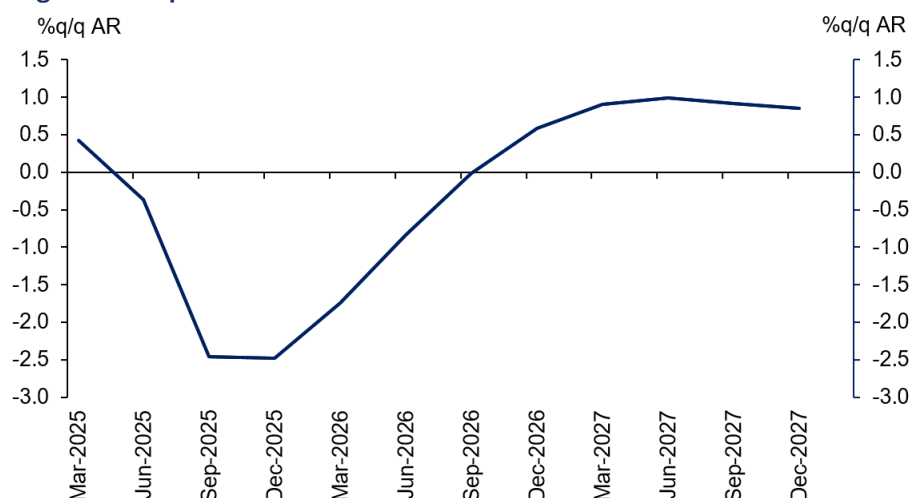
The level of trade policy uncertainty under Trump I paled in comparison to what we are seeing today. No matter what happens going forward, the current level of uncertainty is likely to have a sizable negative impact on GDP over the balance of this year. Our US Economics team has replicated and extended the Caldera et.al. Fed staff analysis. They estimate that even if trade policy uncertainty recedes quickly from its recent peak, the damage to growth later this year will be substantial—enough to reduce H2 real GDP growth by more than 2% pts (Chart 12).²³ With the effective tariff rate assumed to recede to around 15%, they expect US real GDP growth for the year as a whole to be reduced by 1.5% pts—weak but not quite recessionary.²⁴ They also acknowledge that risks are skewed to the downside given the potential for greater negative effects from trade policy uncertainty.

²² See Caldara, Iacoviello, Molligo and others, "[The Economic Effects of Trade Policy Uncertainty](#)," International Finance Discussion Papers no 1256, Federal Reserve Board 2019

²³ See Luzzetti, Ryan, Weidner and Yang, "[US Economic Perspectives: There's too much confusion, I can't get nor relief](#)," Deutsche Bank May 8, 2025

²⁴ See Luzzetti, Ryan, Weidner, Yang, and Dasgupta, "[US Economic Perspectives: US outlook: Tariff-struck](#)," Deutsche Bank April 14, 2025 and Luzzetti, Ryan, Weidner, and Yang, "[US Economic Perspectives: Chinese tariff wall starts to come down](#)" Deutsche Bank May 12, 2025

Figure 13: Impact of current TPU on Real GDP



Source: BEA, Haver Analytics, Deutsche Bank

Finally, tariffs at this level are expected to push core PCE (consumer price) inflation up into the range of 3.5-4% later this year assuming the passthrough of tariffs to domestic prices remains in its historical range of 50% to 75%. The effects are not expected to appear for another month or two because of lags observed in past tariff actions. Inventories built up in anticipation of the tariffs need to be worked off before post-tariff prices begin to show through.

Section 6. How much could other Administration policies reduce the trade deficit?

This section analyzes the potential impact of Trump Administration policies other than trade policies on the US trade deficit. In particular, it considers: (1) Budget policy's effect on the saving-investment imbalance, (2) Immigration policy's potential to hinder trade deficit reduction, and (3) Pressure on Europe to increase NATO funding and its potential impact on European saving and investment. It also notes the possible effect of Fed policy.

Budget policy. A significant reduction in the budget deficit could greatly help to narrow the external deficit, but several factors present challenges to this outcome:

- A strong desire to extend most if not all of the Trump I Tax Cuts and Jobs Act (TCJA) and implement other tax cuts, including:
 - Elimination of taxes on tips, overtime wages, and Social Security income
 - Increasing the state and local tax deduction, the standard deduction and the child tax credit.
- Desired increases in spending on defense and homeland security.
- Strong opposition to significant cuts in entitlements, including Medicaid by the president and moderate Republicans.

DOGE cuts and other cuts in discretionary employment and spending have made a splash in the press, but actual cuts in spending so far have been relatively small. That said, DOGE-driven cuts in staff at the IRS will degrade the enforcement of tax collection and by some estimates could reduce revenue



collected by hundreds of billions of dollars annually. Investment in artificial intelligence could make up some of gap, but that will likely take time to implement.

Tariff revenue could provide some offset. With imports of goods running at \$3.5 trn annually, a 10% universal tariff would raise \$350 bn assuming no change in imports. Tariffs on goods in some sectors (cars, steel, aluminum, and possibly pharmaceuticals) and from some countries (China and very possibly others) will be higher, tending to raise revenue. But the tariffs will also reduce imports, as they are intended to do, thereby reducing total revenue collected.

Other policies that could be counterproductive in reducing the trade deficit include:

- **Monetary restraint by the Fed** in the face of tariff-induced increases in prices, which would tend to cause the dollar to appreciate, everything else equal. We recognize this is a preferred outcome over monetary accommodation and letting inflation go.
- **The tightening of immigration controls** and stepped-up deportations, which will tend to dampen foreign demand for tourism and higher education in the US, both important service sector exports. The resulting reductions in labor supply will also make expansion of employment and output in import-competing sectors more difficult.

Geopolitical. One area where Administration non-trade policies could pay off for trade-deficit reduction is in the geopolitical arena. The Trump Administration's pressure on Europe to foot more of the support for NATO and the war in Ukraine has had results. Our European Economics team estimates that the resulting German-led increase in deficit spending on defense could add as much as 1% pt of GDP to the euro area's budget deficit over the next year or two.²⁵ Some of this spending will be on US-produced military hardware, but even just the reduction in saving will be a move in the right direction.

The **bottom line on non-trade policies**, is that the scope for meaningful trade-deficit reduction is limited, largely because of political challenges faced in addressing the US budget deficit. In this regard, the European shift toward deficit spending on defense is the most promising development.

Section 7. A possible (and preferred) path to zero trade balance.

Any significant reduction in the US trade deficit will mean narrowing the gap between domestic saving and investment. This will be a painful process no matter how it is engineered. That is, unless productivity and output can somehow be induced to grow much faster—which seems unlikely until humanoid robots governed by artificial general intelligence appear on the scene in large numbers.

The external deficit is an important problem. But it is not an imminent crisis. As Charles Schultze used to say about the US budget deficit, it is termites in the woodwork, not the wolf at the door.²⁶ Going cold turkey on trade with China, discarding the world trade system, causing recession and huge wealth loss for US households is not warranted. Actions taken can be more measured. The risk, of course, is that absent crisis mode, any painful actions will be avoided.

In any event, if one were king, this is how one might ideally assess and deal with the problem:

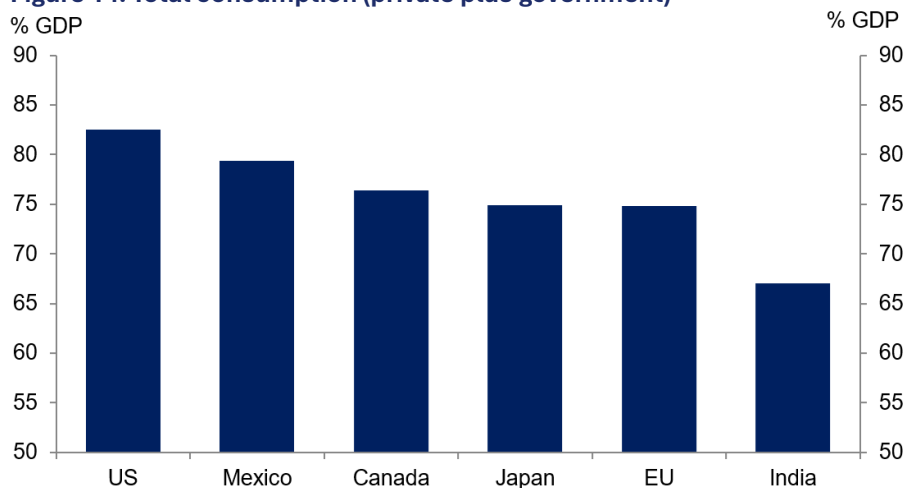
²⁵ See Mark Wall and Clemente Delucia, "[Defending Europe: Limited Escape](#)," Europe Blog, Deutsche Bank Economic Research, May 1, 2025

²⁶ Schultze was a prominent economist at Brookings who served as Chairman of the Council of Economic Advisers under President Jimmy Carter in the late 1970s. Of course, the national debt as a share of GDP was at the time about one-fourth its current level. The termites have been toiling hard.



First, the assessment: As indicated in Charts 14,15, by international standards, the US has a relatively high rate of consumption and low saving relative to investment. Major US trading partners tend to save more than they invest, although Canada and Mexico are modest exceptions. These differences are reflected in relative external balances in Chart 16.

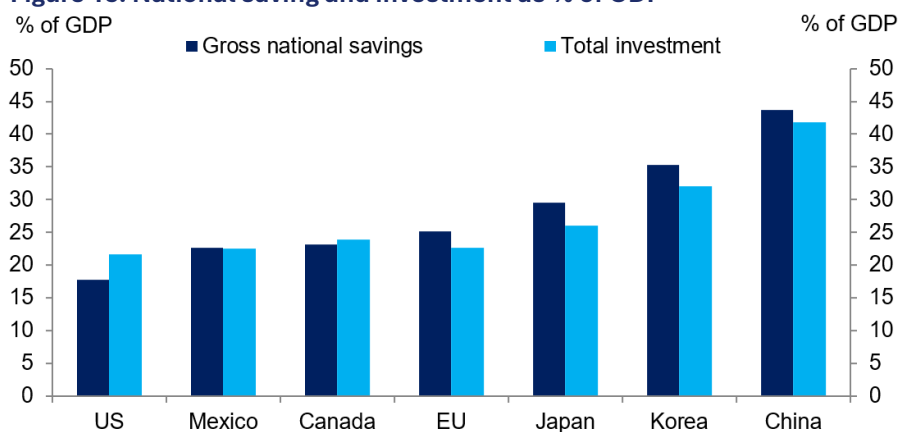
Figure 14: Total consumption (private plus government)



Note: The bars show average of 2000 – 2024.

Source: Haver Analytics, IMF, Deutsche Bank

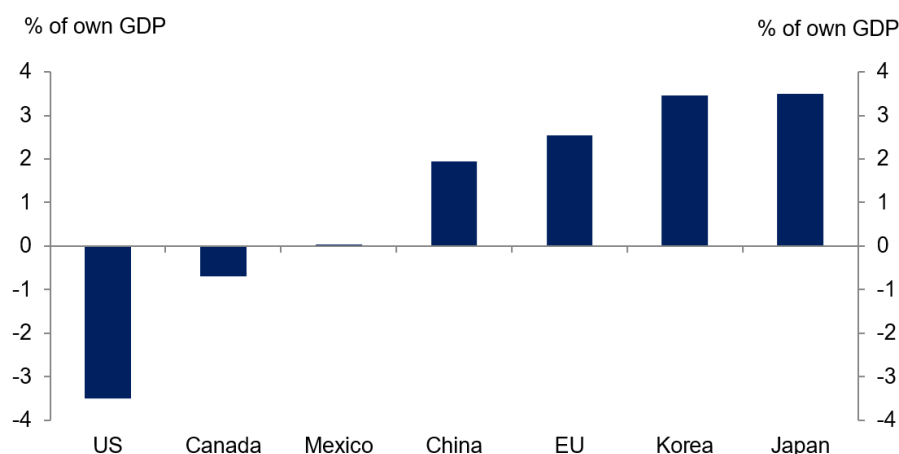
Figure 15: National saving and investment as % of GDP



Note: All the bars are average of 2020-24 for each country.

Source: IMFWEO, Haver Analytics, Deutsche Bank

Figure 16: Overall external balances for US and major trade partners



Note: Five-year averages (2020-24) of current account balances.

Source: IMFWEO, Haver Analytics, Deutsche Bank

How to deal with the problem: The most powerful way to deal with these gaps from a US perspective is via budget deficit reduction. Something, by the way that would be highly desirable in its own right. One would also recognize that tariffs are a significantly more costly way to raise revenue than many other forms of taxation because they induce retaliation, uncertainty, and economic inefficiency and because they are regressive (i.e., tax the poor proportionately more than the well off). Hence a recommended course of action would be to:

- **Remove all tariffs** implemented this year, while holding in reserve for negotiations those targeted at countries that have significantly elevated restrictions on imports from the US or other unfair trade practices that hinder US exports. (The objective here is to negotiate a more level and unrestricted playing field for US trade flows).
- **Reduce budget deficit by:**
 - Working with Congress to find ways to adjust the tax code in order to significantly raise the revenue share (taxes collected/GDP), by:
 - Raising the top bracket while extending the TCJA for lower and middle-income households.
 - Gradually moving toward a consumption tax with income redistribution to neutralize its regressivity.
 - Cutting massive tax expenditures (all sorts of tax breaks),
 - **Hiring back all the IRS** personnel let go and then some, at least until AI can effectively take their place.
 - Embarking on meaningful **reform of entitlements**, including raising the retirement age and transitioning away from the current fee for service approach to medical care toward incentivizing managed care that prioritizes preventive care.
 - **Strengthening removal of fraud**, abuse, and/or needless inefficiency (if and where it exists) by reinstating inspectors general and the GAO who were let go early on, and making full use of the large scale reductions in spending across the board that these entities have identified over the years.
 - In general, **substituting scalpel for chain saw** in thoughtfully cutting back spending where warranted.



Reduce foreign saving. To deal the saving-investment imbalance from a foreign perspective, one would ideally keep the pressure on countries with relatively high saving rates to work to reduce them via fiscal expansion and other measures.

Dollar depreciation. To the extent that such shifts in fiscal policy at home and abroad could be realized, one would welcome their implications for dollar depreciation. Dollar depreciation is much preferred over tariffs as a route to trade balance adjustment. This both because exchange rate adjustment has proven over the decades to be much more effective in reducing trade imbalances and because uncertainty associated with exchange rate volatility has been much less disruptive to economic activity.²⁷ However, one should be wary of adopting policies more narrowly aimed at driving the dollar lower, for example by taxing capital inflows or by fomenting concerns about the credibility of US macro policy and the dollar's reserve currency role. The dollar's reserve currency role has been the source of much benefit to US residents in terms of seigniorage gains and damping effect on the risk premiums of dollar assets. Attempting to tax or discourage international capital flows as a way to reduce the external deficit could be tremendously disruptive, but that is another paper.

Finally, one cannot lose sight that some of the urgency for dealing with the US trade deficit is to make up for painful losses on the part of workers and communities whose jobs and businesses moved overseas over the decades. It does not make sense to put the whole US economy through a wringer in an attempt to bring back manufacturing that is likely to be much more automated than it was in the past. But certainly more can be done to redistribute some of the tremendous gains from trade via subsidies and other inducements to support retaining of workers and investment in new industries.

The problem with these recommendations is that most if not all will be viewed as politically infeasible in the current polarized US political system. That is a shame. For an Administration that was willing to come in and be disruptive to get things done, this is an opportunity missed. Everyone knows, or should know, that the budget deficit cannot be fixed unless entitlements are reformed--and that with an aging population, the US cannot afford a declining revenue share. More importantly, unless solutions are addressed in a thoughtful/bipartisan fashion, anything wrought today risks being undone after the next election. The pendulum will swing back with the Left working feverishly to reverse what the Right is destroying and building now. The great nation that is the United States was built nearly 250 years ago because its founding leaders on the left and right, our Jefferson-Madisons and our Adams-Hamiltons, despite deep-seated disagreements, came together to get it done. Having a Washington at the helm helped tremendously. Would that Trump could be more Washingtonian in his approach to compromise. He is forging some success in foreign policy. Would that he could strive for the same in more important domestic policy. How does he want to be remembered in US history?

²⁷ Empirical studies have generally found uncertainty associated with exchange rate movements to have relatively small depressing impacts on real economic activity, though it can have more significant effects on prices. See for example, P Hooper and S W Kohlhagen, "[The Effect of Exchange Rate Uncertainty on the Prices and Volume of International Trade](#)," *Journal of International Economics*, 1978. The empirical findings from this early study focusing on US-German trade during the 1960s and 70s, have generally been shown to hold up over the decades in more recent research. See, for example, Peter B Clark and others, "[New Evidence on the Effect of Exchange Rate Volatility on Trade](#)," IMF 2004.



Section 8: Conclusions

Our conclusions briefly address the eight questions raised at the outset of the paper:

What have been the key drivers of the US external balance over time? Drivers of the US external balance have varied. But one ever-present and significant force has been swings in the dollar's broad real foreign exchange value. These swings have reflected a combination of fiscal and monetary policy mixes at home and abroad and trends in saving behavior, especially abroad. A sustained reversal of the dollar's rise over the past 15 years would likely be enough to balance the US trade account.

What underlies the current persistently large trade deficit? The current large US external deficit reflects a combination of several factors, including relatively strong US demand for imports (high rate of consumption) supported by years of fiscal stimulus (large budget deficits) and a strong ("overvalued") dollar. These factors have combined with lower rates of consumption (high saving) especially in China, plus Chinese emphasis on export-led growth supplying global markets with lower-priced goods while engaging in trade practices the US takes issue with.

Are US trade partners significantly more restrictive on trade flows than the US? Going into the current trade conflict, trade restrictions were generally only slightly higher in a number of key US trading partners (the EU, Japan, Korea) than in the US—and in some cases the same or lower (Mexico and Canada). This similarity limits the scope for deals when the US raises tariffs. In other cases (especially China) the differences have been greater and the potential for productive negotiations is greater.

Will tariffs succeed in reducing the deficit and moving manufacturing back to the US? The answer is that they could be moderately successful on both these fronts, more so than implied by the weight of empirical research on this question in the past. We say this for several reasons: (1) because the tariffs are likely to depress imports more than foreign retaliation will depress exports in the present case—i.e., retaliation may be less potent than in the past, (2) because the tariff policy may have fomented a downturn in the dollar, and (3) because the tariffs could induce some reduction in high saving rates abroad via fiscal stimulus. These adjustments will likely take some time, as in years.

Will other elements of Trump Administration policies facilitate this desired outcome? Here the answer is it is a close call. The one area that has been fruitful has been foreign policy and the effective encouragement for Europe (especially Germany) to adopt a more expansive deficit-driven fiscal policy. In contrast, US fiscal policy does not seem to be on a path that will yield a significant reduction in the US budget deficit. Indeed, the risks there lie in the opposite direction. Fed policy restraint in the face of rising prices could be counterproductive if it puts the dollar back on an uptrend. And more restrictive immigration policy will hurt by limiting the supply of labor to generate more import substitution, as well as by damping foreign demand for tourism and higher education services in the US.

What are the potential economic costs of employing tariffs to strive for this outcome? The costs are substantial in terms of increased prices and reduced output and employment in the US in the near term, reduced productivity and economic efficiency in the longer term, as well as the longer-term losses associated with a potential trend weakening in the dollar's reserve currency role.



Are there other more effective and/or less costly ways to achieve this goal?

Yes, including meaningful budget deficit reduction in the US, more fiscal expansion abroad, and acceptance of a weaker dollar that would follow from these measures. The problem is that while much more effective and less costly than tariffs, such actions also seem politically much less attainable at least under the current polarized political framework in the US. Would that the can-do spirit of 250 years ago could reassert itself in that framework.

What are the prospects for US tariffs going forward? This is obviously tough to answer with any confidence. There is a clear possibility that failure to reach acceptable “deals” within the current 90-day pauses will result in the return of some reciprocal tariffs. But the Administration has already shown a readiness to reverse course in the face of potential economic pain. The tariffs on China were reduced sharply in exchange only for China unwinding its retaliatory moves. We can expect that the unpopularity of US tariff policy with the US public will grow as the negative economic impacts (higher prices and reduced output and employment growth) become more evident in the months just ahead. This implies that public pressure will likely build to the point where further reductions in tariffs from current levels are forthcoming.



Appendix: Derivation of the equivalence between the trade balance and Saving-Investment balance.

The equality between the US trade or external deficit and the gap between domestic saving and investment can be derived from the US GDP identity as follows:

(1) GDP or national income (Y) is defined as $Y = C + I + G + X - M$

Where C = consumer spending, I = domestic business and residential investment, G = government spending on goods and services, X = exports of goods and services, and M = imports of goods and services.

The terms $X - M$ comprise the trade balance, which is negative if the US is running a deficit. Note that G, government spending on goods and services, accounts for less than one fourth of total government expenditures. The majority of those expenditures are transfers to households and businesses, including most of spending on Social Security, Medicare, Medicaid, VA benefits, unemployment insurance, agricultural subsidies, business tax credits, and interest on the national debt.²⁸ These transfers effectively increase the income of households and businesses to augment their spending on C and I.

By rearranging terms in the GDP identity, we can define the trade balance as:

(2) $X - M = Y - C - I - G$

Next, if we add and subtract the difference between government tax collections (T) and government transfer payments (TR), we get:

(3) $X - M = Y - C - I - G + (T - TR) - (T - TR)$

Rearranging terms gives us:

(4) $X - M = (Y + TR - T - C) + (T - G - TR) - I$

This equation says that the external balance is equal to the gap between domestic saving and investment.²⁹ Here, saving is broken down into private sector saving (or national income plus government transfers minus taxes and consumption) and government saving (or tax revenue minus government spending on both goods and services and transfers).

The US has consistently run an external deficit because of a relatively low private saving rate and a large government budget deficit. The same identity holds for the rest of the world as a whole in principle, with the sign of the external balance reversed. In practice, however, there is a sizable statistical discrepancy in the cumulation of trade statistics across countries, so that existing data will not show that the US external deficit is exactly equal to minus the sum of other countries' trade (or saving-investment) imbalances.

²⁸ The only portion of Social Security, Medicare, and Medicaid budgets that are counted as "G" are the administrative costs including salaries of Federal workers as well as costs of plant and equipment used to house and run these agencies. These administrative costs are generally well under 10% (on the order of 5-6%) of their total budgets. The great bulk of spending in these areas are direct income payments or payments for medical and other services provided to households.

²⁹ Net exports of goods and services, the external balance in GDP terms, differs slightly from the more frequently cited measure of the external deficit, the current account balance. The current account also includes the net of investment income and wage income receipts and payments across borders that are not counted as part of GDP (gross "domestic" product); but they are part of GNP (gross national product).



Appendix 1

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