

24-7 Misconceptions about US Trade Deficits Muddy the Economic Policy Debate

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Amid the tumult of the 2024 US presidential election, the major political parties' competing policy visions share a deep distrust of economic openness. Both parties are more likely to apply the language of grievance to international trade than the language of opportunity that previous US presidents often used. President Joseph R. Biden Jr. has continued and in some instances intensified the restrictive trade policies of his predecessor, Donald Trump, who now threatens to further up the ante if he returns to the White House in 2025.

Prominently in Trump's worldview, as in that of many fellow Republicans as well as Democrats, the large and persistent US foreign trade deficits that emerged in the late 1990s play a central causal role in US deindustrialization. The negative employment effects of imports from China on US heartland communities—the “China shock”—are a prime source of resentment, often linked to China's trade surpluses. Indeed, much of the current turmoil over US trade policy has roots in the decade between 1998 and 2008. During those years, global current account imbalances reached unprecedented levels, with the US current account deficit touching a record 5.9 percent of GDP in 2006 and China's surplus attaining an astounding 9.9 percent of GDP in 2007.¹

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¹ The current account balance equals the sum of the trade balance (exports of goods and services less imports), net income from the net international investment position, and net transfers from abroad. Because the US trade balance (net exports), which is a component of the demand for GDP, tracked the current account quite closely through the global financial crisis, I will often use the terms *current account deficit*, *trade deficit*, *net export deficit*, and

Implicit or explicit in that analysis is the belief that US deficits with foreign partners were forced on the United States by external events or policy decisions taken abroad—for example, the factors behind China’s big surpluses.² From there, it is a short step for some to conclude that the United States should insulate itself by limiting imports through taxes on foreign trade or quantitative restrictions. However, the idea that the massive US economy has been the helpless victim of foreign economic forces distorts reality and leads to faulty policy conclusions.

This Policy Brief takes issue with macroeconomic narratives that the US external deficits of 1998–2008 were, in the main, imported from the rest of the world. There are two dominant theories. One holds that the United States, by pursuing freer trade, left itself open to unfair competition from trade partners. US imports therefore rose, while exports fell. The other theory, the “global saving glut” theory and its variants, holds that higher net saving abroad created global macroeconomic conditions requiring an appreciation of the dollar and equilibrating US trade deficits. In practice, of course, any separation of a deficit’s drivers into domestic and foreign components is contestable because domestic economic transmission mechanisms mediate the ways foreign shocks operate on the deficit. Moreover, both domestic and foreign shocks are always at work. This Policy Brief lays out the case that the two dominant theories, although compellingly simple, are inadequate. One is just wrong; the other, incomplete.³

Identifying trade liberalization as a primary cause of the deficit is simply wrong. The deficit is the macroeconomic outcome of an economy’s collective decisions to save and invest. Not only is it unclear that freer trade will raise investment more than saving, which it must in order to widen the deficit, but if it does, an investment-driven deficit is likely positive for the economy.

The global saving glut story is macroeconomic in nature, so it is *prima facie* more plausible. Nonetheless, I contend that it is oversimplified and therefore incomplete. It has more validity for the years 1998–2001 during and just after the Asian financial crisis, years during which the US dollar appreciated sharply. It is less compelling over the period 2002–06, when the dollar depreciated and the United States experienced a housing boom destined to end in tears. In that second period, US debt issuance in global markets financed high consumption (relative to income) in tandem with the housing boom, on net pulling in financial capital from abroad. At all times, capital flows out of as well as into the United States, with the gross flows usually much above the net amount needed to cover the current account deficit. For the period 2002–06, however, the US pull on foreign capital dominated the overseas push of foreign capital toward the United States.

external deficit (or surplus) interchangeably. The sum of the current account balance and the capital account balance (which measures capital transfers and the acquisition and disposal of nonproduced nonfinancial assets) equals the increase in net financial claims on the rest of the world, also called the net capital outflow (if net claims vis-à-vis foreigners are rising) or capital inflow (if net claims vis-à-vis foreigners are falling). Because the US capital account balance is usually small, I will identify the current account balance with the net capital outflow, or financial account balance.

2 Yang (2012) surveys how China’s economic structure and policies promoted its exceptionally large current account surpluses of the 2000s.

3 Kenneth Rogoff and I made related points in an earlier paper written close to the 2008–09 financial crisis (Obstfeld and Rogoff 2010). Revisiting the topic seems warranted, however, for two reasons: First, there has been more research. Second, the political aftershocks of the decade ended by the financial crisis have become clearer.

It is important to get the history straight, as it continues to cast a long shadow over current debates on trade policy. Faulty diagnosis can lead to both destructive trade policies and a failure to address domestic economic distortions that harm the US economy.

BLAMING FOREIGNERS

In his recent book, *No Trade Is Free*, former US Trade Representative Robert Lighthizer, who will surely play a prominent policy role in any future Trump administration, writes of the United States that “[O]ur long-term massive [trade] deficits tell the story of a country that has failed to protect its own interests” (Lighthizer 2023, p. 25). One might agree with this general assessment while drawing divergent policy conclusions, but in Lighthizer’s telling, the needed protection is from external economic forces. He lists among these the 1995 birth of the World Trade Organization (WTO), China’s WTO accession in 2001, foreign demand for the dollar as a reserve and safe-haven currency, and alleged underconsumption abroad.

Lighthizer also blames foreign economic policies, including “currency manipulation, targeted government spending on production capacity and related infrastructure, import restraints, an exploitative banking system, labor immobility, wage suppression, and similar schemes. This is unfair trade” (p. 30). Several of his complaints about unfair trade policies are legitimate—they can distort global trade and damage trade partners—but he makes no acknowledgment that some sources of the US deficit and the negative effects critics ascribe to it may be US-based. If so, the United States may have failed to protect its own interests not from foreigners but from itself.

In his review of Lighthizer’s book, Gordon Hanson (2024), a coauthor of one of the fundamental empirical papers on the China shock (Autor, Dorn, and Hanson 2013), pushes back convincingly on the author’s views about the WTO’s role in US trade deficits and the corrective potential of tariffs. As Hanson argues, the trade balance equals exports less imports, but, while trade policies play some role, macroeconomic factors are all-important: Imports rise with total aggregate domestic spending, total spending influences the amount of home product available for export, and the dollar’s foreign exchange value tends to rise when total spending rises. These linkages ensure that the current account balance exactly equals national saving less domestic investment, an identity that follows because any excess of investment over the amount residents save is necessarily financed by capital inflows from abroad. Tariffs and other trade barriers cannot affect the trade deficit unless they shift saving or investment, and for the United States there is scant evidence that they have been a quantitatively significant determinant of either in the recent past.

While Hanson accurately points to the macroeconomic nature of deficits, he joins Lighthizer in locating the deficit’s source in exogenous overseas developments (Hanson 2024, 170–71):

The US trade deficit did rise from 1998 to 2008, before dropping back to 1999 levels in the early 2010s. The cause was not the WTO, but the 1997 Asian financial crisis, after which Asian central banks substantially increased their holdings of foreign reserves, primarily by purchasing US Treasury bills. That resulted in the United States having a bigger capital account surplus, meaning that more capital was flowing into the United States than was flowing out. The United States offset

that account surplus by importing more than it exported. The US trade balance was affected because US Treasury bills remained the foreign asset of choice for central banks around the world, which pushed up the value of the dollar, making imports cheaper and US exports more expensive, causing a large trade deficit.

Hanson's account is a version of the "global saving glut" paradigm of Ben Bernanke (2005), advanced several years after the Asian crisis and just before US external borrowing had reached its peak. In this view, the Asian crisis set off a trend of self-insurance by the crisis countries and others, which accumulated foreign exchange reserves, mostly dollars. Bernanke noted that the global saving increase after 1998 also owed to oil exporters' surpluses, but as in the case of the East Asian surplus countries, these savers desired to hold assets located in the United States, which saw little choice but to accommodate the foreign demand.

Hanson (2024) himself does not conclude that the causal role of capital inflows to the United States justifies limiting them and thereby limiting the mirror-image current account deficit. However, other commentators have. Matthew Klein and Michael Pettis (2020, 214), in a book that Lighthizer (2023) cites approvingly, assert that "The persistence of the American current account deficit can only be explained by excessive savings abroad and the US role in absorbing these excess savings." Pettis (2024) argues that the United States should levy a tax on foreign capital inflows to weaken the dollar and reduce the trade deficit, which he views as the source of a number of ills, such as undermining the operation of comparative advantage.⁴

For Hanson and Klein and Pettis, as well as for Lighthizer, a stronger dollar has played a central role in accommodating wider US foreign deficits. Consistent with this view, Trump's economic team plans to pursue a weak dollar policy if he is elected, possibly pressuring the Federal Reserve to help bring this depreciation about.⁵

FITTING THE FACTS

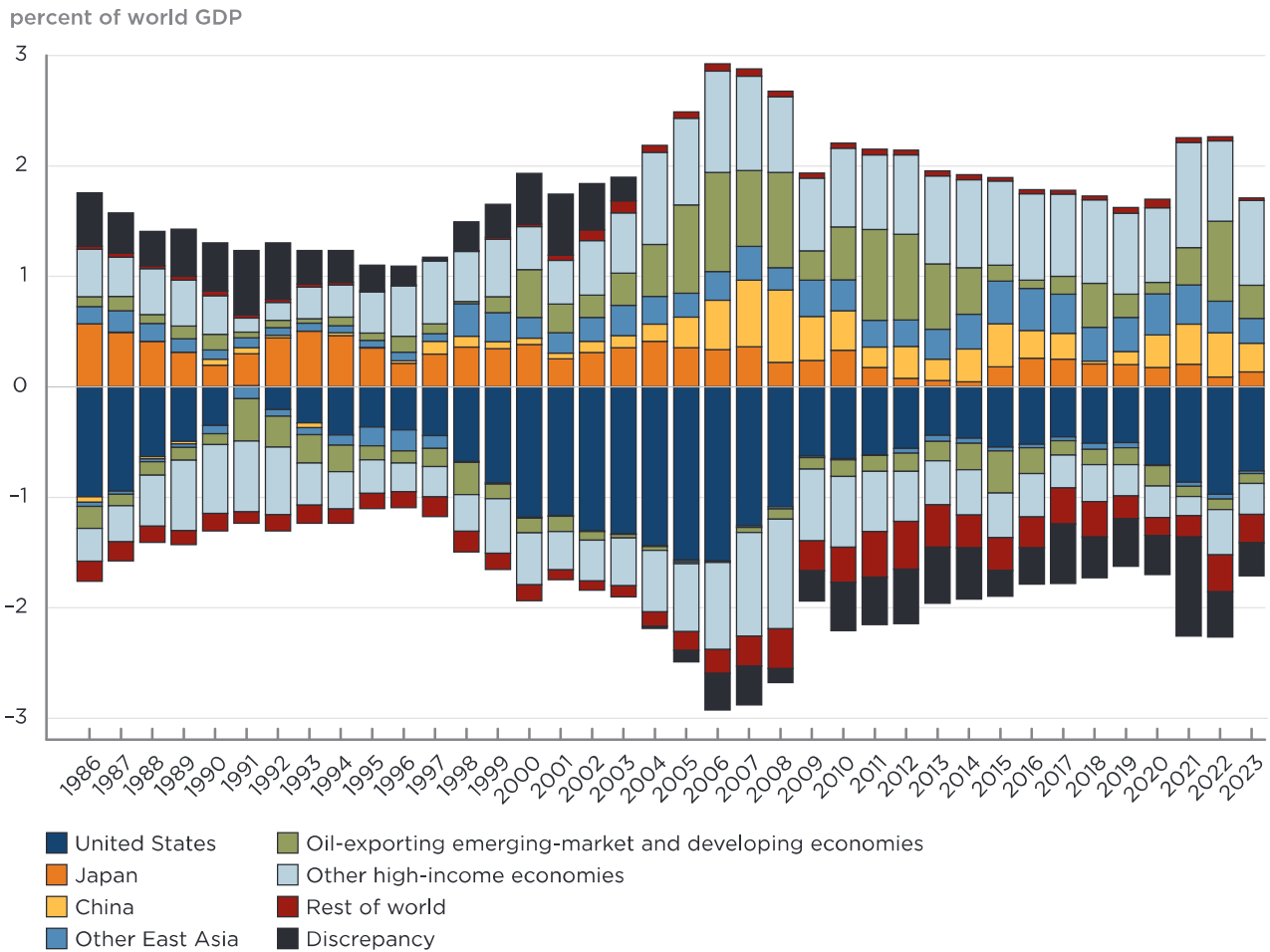
Figure 1 shows the evolution of global current account imbalances since the mid-1980s, when the US deficit reached a then-unprecedented high point under the Reagan administration. The black bars are the statistical discrepancy in the global current account balance, a discrepancy due to measurement errors in balance of payments statistics. I define it as the missing current account surplus (when positive) or deficit (when negative) that would make the sum of all countries' current account balances equal to the theoretical value of zero. When it is positive, for example, total measured surpluses fall short of total measured deficits.

Global imbalances expanded sharply in the 1998–2008 decade, before retracting in 2009. At their height, in 2006, they reached nearly 3 percent of global GDP. As figure 1 shows, the dominant fact of 1998–2001 (when the expansion began) is the rise of the US deficit. No imbalances on the surplus side of the ledger, including those of "other East Asia" (which includes newly industrialized Hong Kong, Korea, Singapore, and Taiwan), are comparable.

4 I analyze some drawbacks of taxing US capital inflows in Obstfeld (2024).

5 See Bade (2024) and Wilcox (2024).

Figure 1
Gross global current account imbalances by country group, 1986–2023



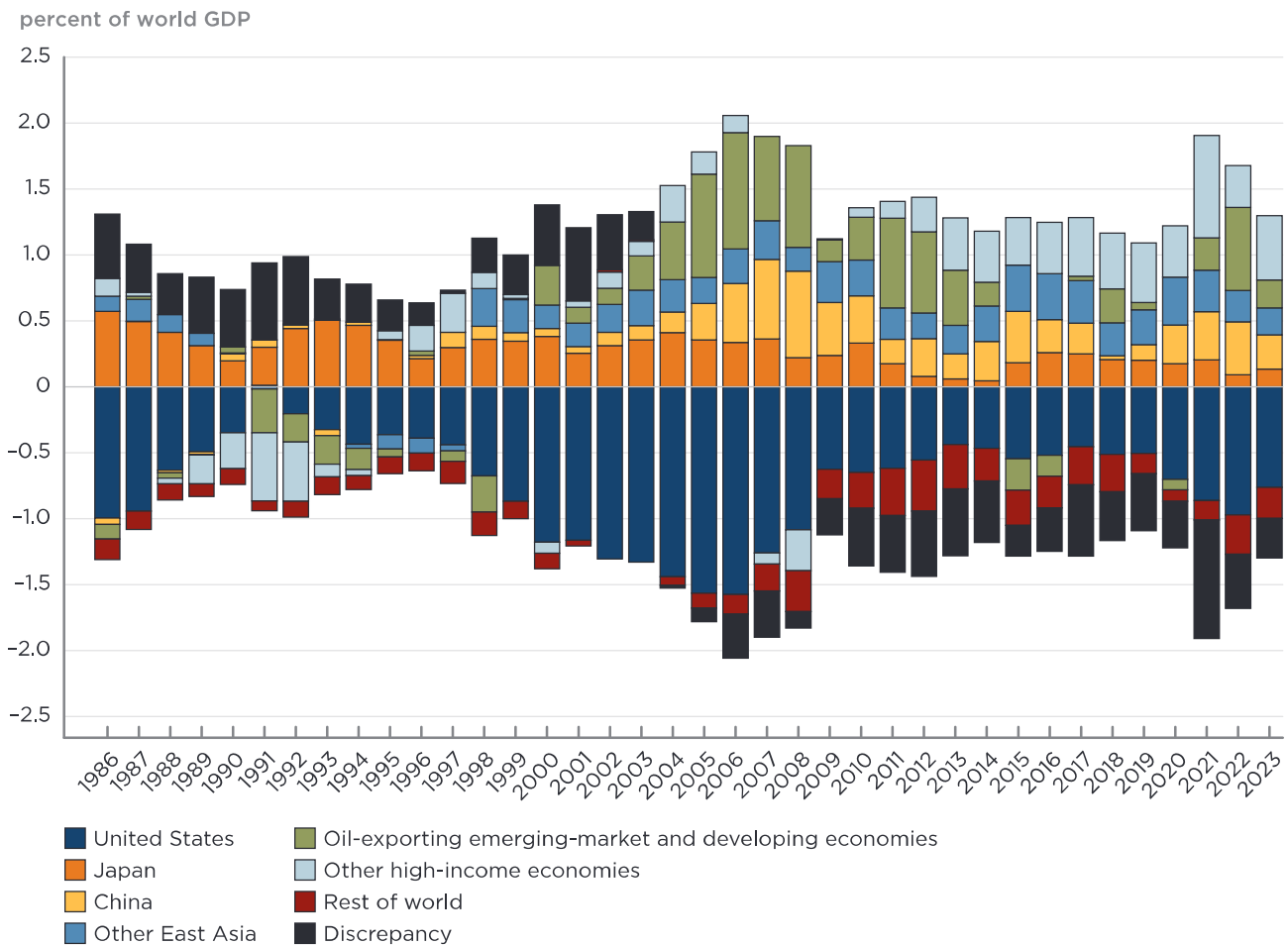
Sources: IMF, World Economic Outlook database, April 2024, with China data before 1997 from World Bank, World Development Indicators.

These data would be enough to rule out the Asian crisis countries as a major driver of US deficits (except perhaps in 1998) but for the unexplained global discrepancy that also begins to grow after 1997, reaching a peak in 2001. At the global level, through 2003 there was a “missing current account surplus” that cannot be attributed reliably to any set of countries. It seems unlikely that the discrepancy is entirely due to unreported surpluses of Asian crisis countries, but based on currently available information, there is no way to know for sure.⁶

Netting surpluses and deficits within country groupings leads to the alternative summary of global imbalances shown in figure 2. Starting in 2003, the net surplus of oil-exporting emerging-market and developing economies (EMDEs) becomes a more significant counterpart of the growing US deficit, joined by China in 2005. It is also in 2005 that the missing global surplus becomes a noticeable missing global deficit, as the sign of the discrepancy flips.

6 Analysis by Helbling and Terrones (2009) suggests that this development reflects a big increase in unrecorded merchandise trade exports.

Figure 2
Net global current account imbalances by country group, 1986–2023



Sources: IMF, World Economic Outlook database, April 2024, with China data before 1997 from World Bank, World Development Indicators.

For 2005–08, most of the net current account deficits shown in figure 2 have their counterparts among the oil-exporting EMDEs, China, and Japan.

Three tentative conclusions follow from simply inspecting the pattern of global imbalances: Asian crisis countries are unlikely to have played the dominant role in the US deficits of 1998–2008; oil surpluses are a consistently big counterpart of US deficits since about 2003; and Chinese surpluses become significant, but not until later in the decade. It is worth underlining again, however, that the global current account discrepancy early in the decade makes it hard to ascertain precisely the counterpart surpluses to the United States' position as the historically massive US deficit is emerging.

CLUES FROM THE DOLLAR

Proponents of the global saving glut theory posit that foreign demand for US assets strengthened the dollar, helping to drive the trade balance more deeply into deficit. This simple narrative seems plausible on its face, but the behavior of the dollar over 1998–2008 suggests a more nuanced account.

Figure 3

Nominal and real effective exchange rates of the US dollar, January 1994–December 2023

Note: Both series are rebased to equal 100 in January 1994.

Source: Bank for International Settlements (BIS), monthly broad dollar indexes.

Figure 3 shows the dollar's nominal and real effective exchange rates. The dollar started rising in the mid-1990s and continued until the second quarter of 2002, possibly consistent with increases in foreign investors' demand for dollars. But then it began to depreciate markedly, a process that continued through the third quarter of 2008.

That long depreciation phase is inconsistent with the theory that foreign capital inflows continued to bid up the dollar, expanding the US trade deficit by making US exports less competitive internationally and imports cheaper for US consumers. In fact, after falling from 1997 (when they were 11.1 percent of GDP) to around 9 percent of GDP in 2002–03, US exports began to expand strongly and steadily (to 12.4 percent of GDP in 2008) until the Lehman Brothers failure threw the global economy into a tailspin. The US net export deficit grew nonetheless because imports rose even more quickly than exports.⁷

Table 1 shows changes in the US current account/GDP ratio and the dollar's nominal exchange rate over subperiods of 1997–2009. Between 1997 and 2002, the US external deficit/GDP ratio swelled by 2.5 percentage points as the dollar appreciated by 20 percent. This is the period for which Bernanke's (2005) global saving glut account is most plausible, though as I have shown, the counterpart surpluses cannot be fully identified in the data (owing to errors and omissions) and the measured Chinese surplus remains quite moderate over this period. Over 2002–06, however, the US external deficit grew by 1.7 percentage points of GDP as the dollar depreciated by 14 percent. This is inconsistent with the view that capital inflows from abroad (a global saving glut) induced a bigger US deficit by expanding the demand for US assets and strengthening the dollar. However, this period features two factors stressed in global saving glut theories: the expansion in China's current account surplus and in those of oil-exporting EMDEs.

7 Of course, this was also a period when global value chains expanded, raising gross exports more than exports of US value added via intermediate imports embodied in US-exported products. However, the US trade deficit does not expand as a result of more intermediate imports that are used in and reflected in the prices of US exports.

Table 1

Changes in the US current account/GDP ratio and in the dollar's effective nominal exchange rate, 1997-2009

Time period	Change in ratio of current account to GDP (percentage points)	Change in US dollar effective nominal exchange rate (percent)
1997-2002	-2.5	20.3
2002-06	-1.7	-13.6
2006-07	0.8	-9.0
2007-08	0.4	9.9
2008-09	2.1	-7.6

Note: Nominal effective US dollar exchange rate is the monthly Bank for International Settlements (BIS) nominal broad dollar index. Annual changes in the exchange rate over a period are log differences between January values; for example, the change in exchange rates in 2002-06 is calculated as the change between January 2003 and January 2007. Positive changes are nominal effective appreciations.

Source: US current account data from IMF, World Economic Outlook database, April 2024.

The rest of table 1 breaks out three especially turbulent years. In 2006-07 the US housing boom ended, the US deficit/GDP ratio shrank by close to 1 percentage point (despite a widening of the overall East Asian surplus), and the dollar fell 9 percent, with the US recession commencing in December 2007. The following year, the dollar appreciated sharply because of panic in world financial markets, accompanied by a moderate reduction in the US deficit. A much more significant reduction in the US deficit, of 2.1 percentage points of GDP, occurred in 2008-09 as the US recession deepened, the Fed launched its first quantitative easing initiative, and the worst of the global financial panic passed.

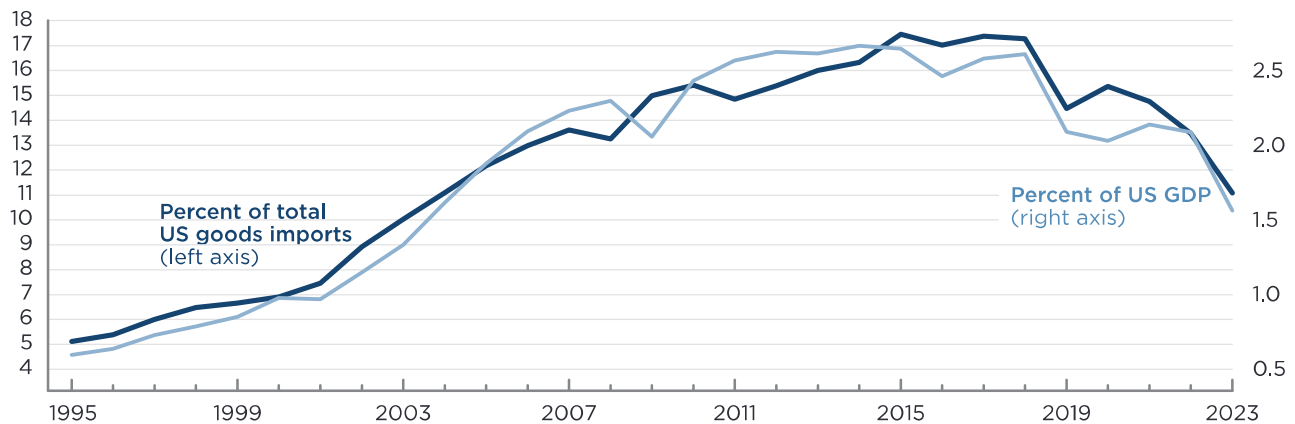
One implication of the table is the lack of a simple relationship between year-to-year movements in the dollar's exchange rate and the current account. While a dollar depreciation cheapens US exports for foreigners and raises the US cost of imports, US net exports may nonetheless fall if US overall spending, including on tradable goods, rises at the same time, as illustrated by the substantial US deficit increase of 2002-06.

THE US DEFICIT INCREASE OF 2002-06 WAS LARGELY MADE IN AMERICA

A further widening of the US external deficit over 2002-06 looms large in common narratives about US deindustrialization. In those years China's current account surplus began to surge (figures 1 and 2), as did its exports to the United States (figure 4), while the share of US manufacturing employment plummeted. At the same time, however, the dollar depreciated significantly. The deficit grew sharply despite a weakening dollar as swelling US spending drove the country's trade more deeply into deficit.⁸ As noted above, US exports grew, but imports grew even faster.

⁸ Klein and Obstfeld (2019) show the empirical relationship between US manufacturing employment and the dollar since 2000.

Figure 4

US goods imports from China in relation to total US goods imports and GDP, 1995-2023

Sources: US Census and US Bureau of Economic Analysis.

A summary of the mechanisms at work is that low US interest rates and especially the easing of other US financial conditions allowed a big increase in home prices as well as in equity prices and consumption spending, accompanied by a weaker dollar. Higher consumption spilled over into imports and nontraded US products, drawing resources from the manufacturing export sector and raising the net export deficit at the same time. Despite a higher overall level of US consumption spending, a demand switch from import-competing goods toward cheaper Chinese imports helps explain the China shock—and this switch would have occurred even if the US trade deficit had been smaller.⁹

Higher capital inflows into the United States (the counterpart of the increased foreign goods and services deficit) are more accurately viewed as the consequence, not the cause, of these developments. True, the Federal Reserve's interest rate policy and the behavior of longer-term US bond rates were in part a response to globally lower interest rates and global demand for safe US assets, but the case that capital inflows to the United States were the primary cause of the US housing bubble or current account deficit is weak. These arguments have been presented in detail elsewhere (Obstfeld and Rogoff 2010) and supported by subsequent research, some of which is discussed below.

Perceiving a weakening US economy, the Fed initiated a loosening cycle in January 2001, pushing the US policy rate below key European policy rates. Jane Dokko and colleagues (2011, 265) note that “the federal funds rate entered previously rarely navigated waters in 2003 and 2004 and was at the low end of the historical range of the previous five decades,” prior to the Fed's initiation of a gradual tightening cycle in mid-2004. The stance of current and expected future US monetary policy helped drive the dollar's depreciation starting in the first quarter of 2002. Accommodative monetary policy also supported US

⁹ General equilibrium models with labor market frictions, such as Dix-Carneiro et al. (2023), point to an ambiguous relationship between trade imbalances and employment.

consumption and home price appreciation, although the strength of these effects is contested (Dokko et al. 2011).¹⁰

Several other research studies have disputed the contention that higher capital inflows to the United States fueled the housing boom by inducing lower US interest rates. David Laibson and Johanna Mollerstrom (2010) point out that a global saving glut should have triggered a US domestic investment boom. However, private nonresidential US investment rose only slightly between 2001–02 and 2005–06 while residential investment increased by more as a fraction of GDP. The authors see this as evidence that a housing asset price bubble, not high foreign saving, fueled consumption and the deficit.¹¹ Andrea Ferrero (2015) argues that US credit and preference shocks are the main explanation for the negative correlation between home prices and the current account. Jack Favilukis and colleagues (2013) contend that foreign capital inflows into safe US assets—for example, foreign central bank purchases of US Treasuries—have two opposite effects on American house prices that are roughly offsetting: While these flows lead to lower interest rates, thereby supporting house prices, they simultaneously push US residents into riskier assets and thereby tend to raise domestic risk premia and lower the price of housing. According to Favilukis et al. (2013, 238), “the sharp rise in price-rent ratios during the boom period must be attributed to an overall decline in risk premia and *not* to a fall in interest rates.” They document extensively the empirical weakness of links between capital inflows to the United States and home prices.

Along with Dokko et al. (2011) and Ferrero (2015), Favilukis et al. (2013) instead tie the housing boom to financial market innovations that made it easier for borrowers—mortgage borrowers in particular—to issue debt. These innovations include the rapid growth in nontraditional mortgages and looser lending standards due to the spread of the originate-to-distribute lending model. Housing appreciation, in turn, further loosened collateral constraints. Even if the *net* capital inflows central to the saving glut story did not cause the housing boom, but instead in large measure reflected the boom, gross foreign capital inflows to housing finance, themselves financed by capital outflows from the United States, played an important role in easing US financial conditions generally (Acharya and Schnabl 2010, Bertaut et al. 2012).¹²

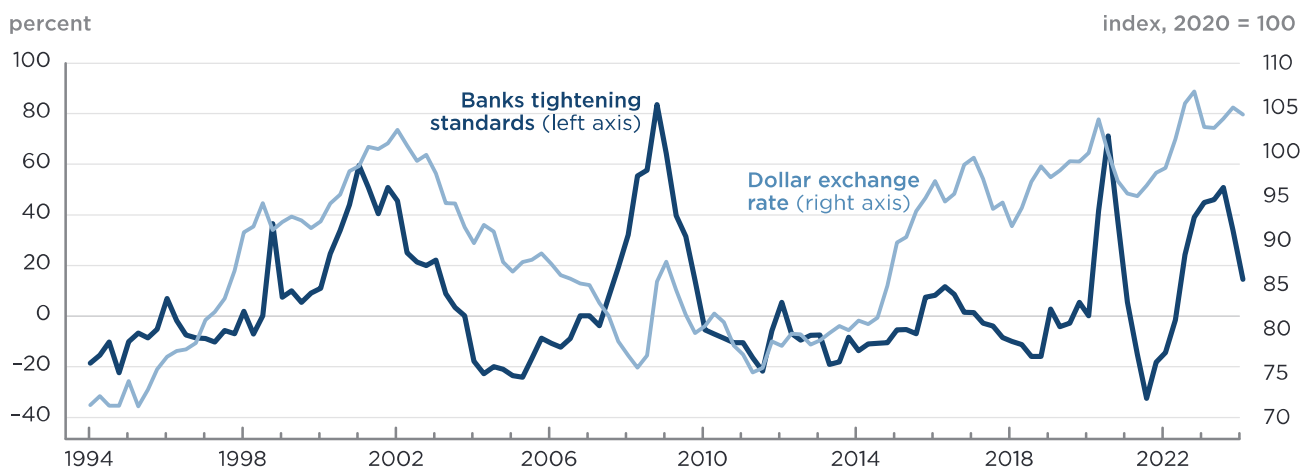
Peter Lihn Jørgensen (2023) brings these themes together in a dynamic macroeconomic model that explains US housing appreciation in 2000–02 as the product of a global saving glut but attributes the subsequent appreciation up to

10 Dokko et al. (2011) point to Fed policy as being broadly consistent with the central bank’s dual mandate (if at the low end of the historical mandate-consistent range), but also suggest that only a very big interest rate hike could have materially restrained the housing bubble. Interestingly, Holston, Laubach, and Williams’s (2023) estimates of the inflation-neutral nominal policy rate of interest for the United States (assuming a plausible expected inflation rate) are notably higher than the Fed policy interest rate or US market rates during much of the early 2000s.

11 US gross private nonresidential investment was 17.3 percent of GDP in 2001, 16.6 percent in 2002, and 16.8 percent in 2005, rising to 17.5 percent in 2006. Residential investment rose from 4.8 percent of GDP in 2001 and 5.1 percent in 2002 to 6.9 percent in 2005 and 6.1 percent in 2006 (the year the housing bubble began to unravel). Alongside a decline in the gross private saving rate from 19.7 percent of GDP in 2002 to 18.7 percent in 2006, an additional factor was fiscal policy, as net US government saving declined in 2003 and 2004 compared with 2002. By 2005, however, this fiscal deficit measure was smaller, albeit much higher than its value in 2000, which showed a surplus of government saving.

12 Boz and Mendoza (2014) offer a broader discussion of US financial liberalization measures starting in the mid-1990s.

Figure 5
Bank lending standards and the nominal dollar exchange rate, January 1994–January 2024



Note: The "banks tightening standards" series shows the net percentage of banks tightening their standards for commercial and industrial loans to large and middle-market firms.

Sources: Bank lending standards data come from the Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS), collected by the Board of Governors of the Federal Reserve System, via Federal Reserve Economic Data (FRED) (series DRTSCILM). Broad effective nominal exchange rates for the dollar are BIS data, via FRED (series NBUSBIS), converted from monthly to quarterly data.

2006 to looser US borrowing constraints. The model also captures the steadily growing US current account deficit between 2000 and 2006, together with the dollar's appreciation in the first phase of this period and its depreciation in the second phase.

It is worth restating that the dollar's depreciation over 2002–06 in the face of a growing US current account deficit stems from the common drivers of both phenomena: lower US interest rates and, especially, looser financial conditions owing to an easing of constraints on domestic borrowing. Those factors drove housing appreciation and consumption growth that spilled over into imports, causing the latter to grow faster than exports. They also encouraged dollar depreciation through the conventional interest rate channel and because relaxed borrowing constraints allowed US residents to issue higher volumes of dollar-denominated debt in world markets. Facilitating that process was the private label securitization boom allowing the conversion of illiquid loans into tradable dollar bonds.¹³

Recent academic studies support the theme that easier US (and global) financial conditions correlate with a weaker dollar (for example, see Avdjiev et al. 2019). Figure 5 illustrates this, plotting the dollar's nominal effective exchange

13 Blanchard, Giavazzi, and Sa (2005) noted the dollar's strong appreciation until the second quarter of 2002 and its subsequent fall. They attributed the initial appreciation to strong foreign portfolio demand for dollars, which also increased the US current account deficit, consistent with the global saving glut hypothesis. However, they attributed the subsequent depreciation to a portfolio effect, namely, the decline in global dollar demand resulting from the transfer of wealth from US residents to foreign residents via the higher US external deficit. Of course, their paper appeared several years before the fragility of the advanced economies' financial systems became apparent in the global crisis. The relative weakness of the euro just after its launch on January 1, 1999, may have contributed to dollar strength before 2002. Euro banknotes and coins were first introduced on January 1, 2002, and the dollar's appreciation cycle began not long after.

rate against Federal Reserve data from the Senior Loan Officer Opinion Survey (SLOOS) on the net percentage of US banks tightening their standards for commercial and industrial loans to large and middle-market firms. There is a marked coherence between the stringency in credit standards and the strength of the dollar; the correlation coefficient between the two series in quarterly 1994–2023 data is 0.39.

CONCLUSION

Popular accounts of the 2000s (e.g., those of Klein and Pettis 2020 and Lighthizer 2023), promote a narrative in which foreign trade surpluses necessarily cause US trade deficits, shrinking US exports and hollowing out America's industrial base. In those narratives, foreign surpluses may arise from unfair trade practices, which advantage foreign exports and discriminate against imports from the United States. Alternatively, foreign surpluses may result from excessive saving abroad, reflected in capital inflows that push into US financial markets, mechanically fueling an equal and opposite trade account response. More nuanced proponents of a global saving glut following the late 1990s Asian crisis likewise tend to place the sources of US trade deficits abroad.

But trade partners' commercial policies are an unlikely explanation for US trade deficits, the roots of which are primarily macroeconomic. The global saving glut hypothesis, however, has value in explaining the initial expansion of the US external deficit between 1998 and 2001, although gaps in balance of payments data obstruct a full assessment. The hypothesis is much less applicable to the further expansion of the US deficit afterward—the period of most rapid US housing appreciation, but also of more rapid growth in US imports from China.

In those years, a widening external deficit was substantially driven by domestic US factors, notably the housing boom, which itself was not caused primarily by net capital inflows. The major causal factor was the ease of financial conditions in the United States in the form of relaxed borrowing constraints facilitated by financial innovation. Lower interest rates likely played some role as well, but possibly a subsidiary one. For the most part, foreign capital did not push in during 2002–06, it was pulled in. A strong indication of the changed dynamic was the dollar's very different behavior over 1997–2001, when it appreciated, as compared with 2002–06, when it weakened.

The latter period illustrates that a weaker dollar today would not necessarily be associated with a reduced US trade deficit. The policies pursued to weaken the dollar would be all-important. They would not necessarily reduce the deficit and might inflict considerable collateral damage.

Both major US political parties have become more hostile to international trade in this millennium, viewing trade deficits as a cause of deindustrialization and tariffs or other trade restrictions as potential antidotes. But the ills that are blamed on trade (as well as other ills) owe in large part to purely domestic policy failures that no degree of trade restriction can repair.

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