5. Professor Ricardo Reis

Take a country that uses tariffs to eliminate the (large) bilateral trade deficit it has with some of its trading partners, while at the same time runs a large public deficit.

What are the consequences of such a mix of policies on its overall current account, its compositions, the exchange rate and domestic employment?

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Essay Question	5
Word Count	1500

1. Introduction

"We're gonna win so much you may even get tired of winning." While the promise of 'winning' remains debatable, one thing is certain – the world has gotten 'tired' of (President of the United States) Donald Trump's trade war. During his first presidency, Trump framed the trade deficit with China as evidence of being "*ripped off*", responding with tariffs proportional to the deficit to reduce it [(1)]. While these measures reduced the bilateral deficit with China by 26% [(2)], it also triggered trade diversion, widening bilateral trade deficits with other partners such as Vietnam and Mexico. Therefore, in his second presidency, he extended proportional tariffs on all nations where United States (US) faced a bilateral trade deficit, totalling over 90 countries [(3)]. Clearly, Trump's agenda has been defined by economic nationalism. And tariffs were just half the story. Across his terms, Trump also spearheaded fiscal expansions, from the 2017 Tax Cuts and Jobs Act (TCJA) to the ongoing proposals for tax cuts and infrastructure spending [(4)]. These expansions have collectively pushed public deficits to $1.1 trillion by April 2025 [(5)].

While these policies may benefit US when pursued individually, their combined implementation bears an inherent policy conflict. Tariffs are intended to curb imports, protect domestic industries and narrow the trade deficit, which greatly reduces the Current Account (CA) deficit as well. Whereas, persistent fiscal deficits, accumulated via former fiscal expansions, worsens the CA deficit. Essentially, tariffs seek to reduce CA deficit, while fiscal policy worsens it. Therefore, this essay will discuss the economic implications of US' policy mix: namely, the worsening CA deficit, the distorted trade composition following tariffs, and unintended, unexpected consequences on currency and domestic employment.

2. Current Account and Trade Composition

2.1. Fiscal Deficit as a factor of US' Current Account Deficit

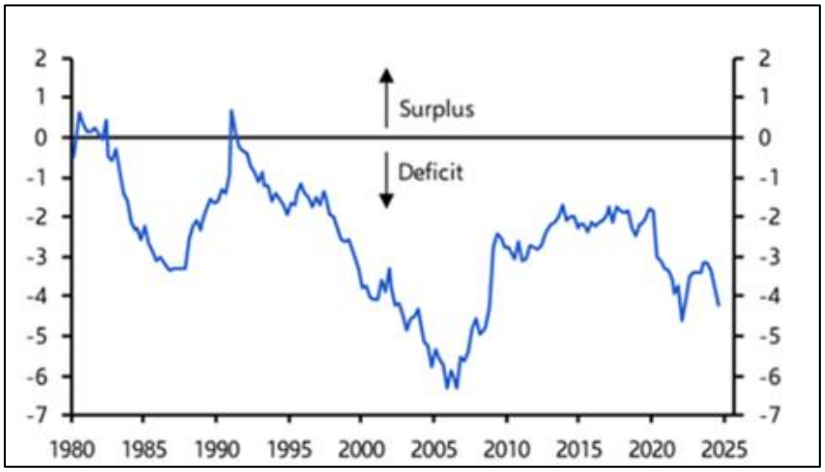

Figure 1: US' CA Balance (as % of GDP) [6]

Since the 1980s, the US has consistently run a CA deficit, which has worsened since 2020s (Figure 1). At first glance, such persistence appears alarming. Trump, for instance, characterised the trend as evidence of US' victimisation by foreign countries; "*trade deficits mean you lose, and surpluses mean you win*" [7]. However, adopting a mercantilist view of international trade for US is simply misguided. The persistent CA deficit is not a problem caused by "*foreigners engaging in nefarious activities*" [8]. Rather, it is a homegrown problem, caused by US' fiscal deficit.

In simplicity, a fiscal deficit needs to be financed by external institutions and nations. Given US' status as global reserve currency, and the presence of strong military and innovative institutions, it sustains high investor confidence [9]. Thus, through the sale of long-term Treasury securities, bonds and other assets, US receives steady capital inflows, creating excess-demand for the US dollar (USD), appreciating it. Consequently, exports become more expensive to foreign consumers, while imports become cheaper for domestic consumers, reducing net exports, worsening the overall trade deficit, widening the CA deficit.

This is the twin-deficits hypothesis, which theorises that a nation's fiscal deficit tends to cause a CA deficit, though dependent on some economic conditions (10). This hypothesis can also be proved through the savings-investment accounting identity in Figure 2. Additionally, Figure 3 shows analogous trends, as theorised by the twin-deficits hypothesis, in China and Japan, where fiscal surplus creates a CA surplus.

$$GDP = C + G + I + X - M$$
$$S = GDP - C - G$$
$$\therefore S = (C + G + I + X - M) - C - G$$
$$S = I + X - M$$
$$S - I = X - M$$

$$CA = (X - M) + \text{Net income from abroad} + \text{Net current transfers}$$
For simplicity, we can consider $CA = (X - M)$

$$\therefore \boldsymbol{CA = S - I}$$
$$\boldsymbol{CA = (S_{private} + S_{public}) - I}$$

Symbol	Full Form
GDP	Gross Domestic Product
C	Domestic Consumption
G	Government Spending
I	Private Domestic Investments
X	Exports (Goods + Service)
M	Imports (Goods + Services)
S	National Savings

Fiscal deficit = Government Spending > Tax Revenue.

$\therefore S_{public} < 0$ (A public savings deficit exists.)

Although US maintains a $S_{private}$ surplus, it is less than half of S_{public} deficit [11].

$\therefore S < 0$ (A national savings deficit exists.)

$\because I > 0 \ \therefore (S - I) < 0$

Thus, a Savings-Investment deficit, or a CA deficit, exists in the US.

Figure 2: Savings-Investment Identity [11]

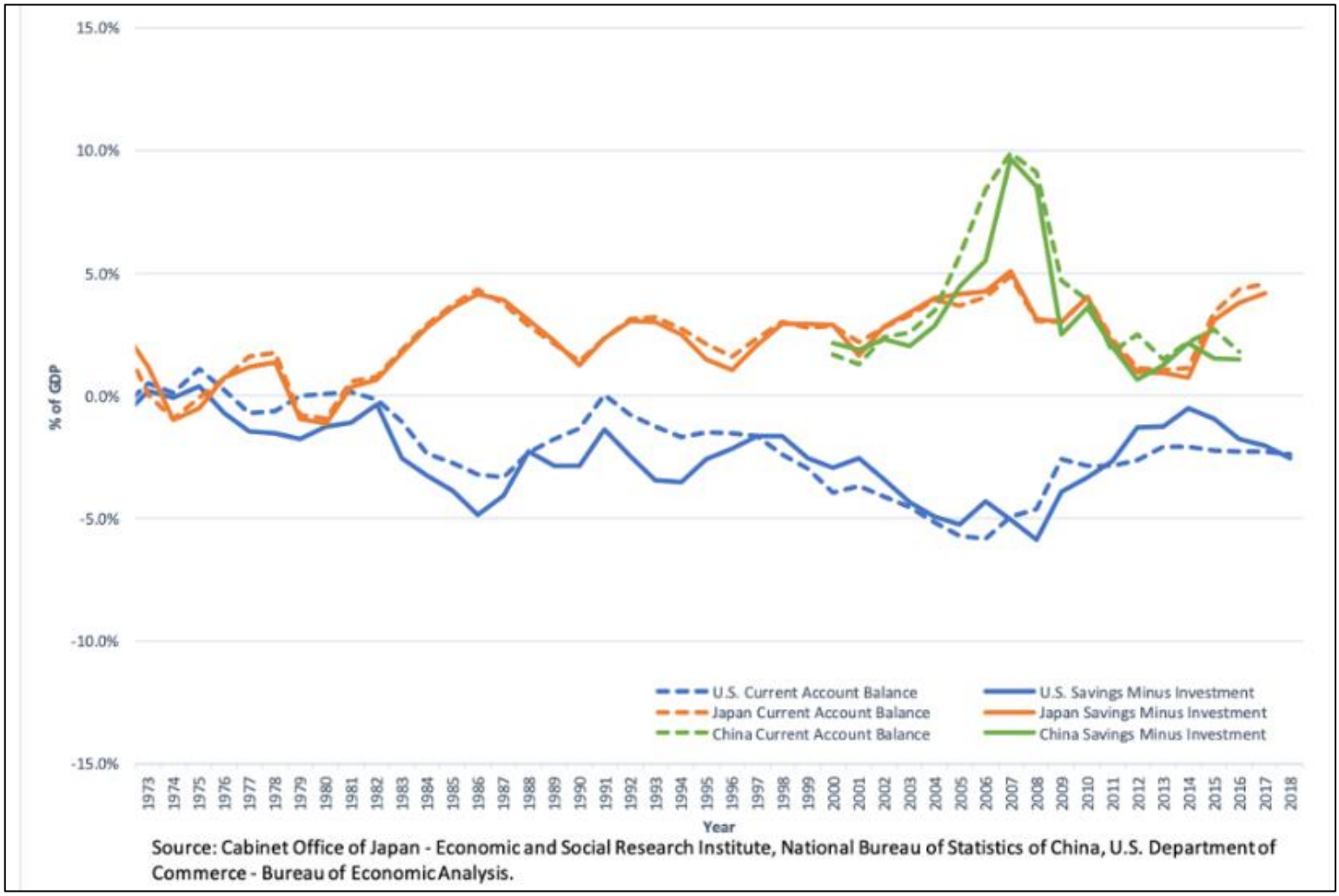

Figure 3: Relation between CA balance and Savings-Investment Gap of USA, China and Japan [12]

2.2. Tariffs' Implications on US' Current Account Deficit and Trade Composition

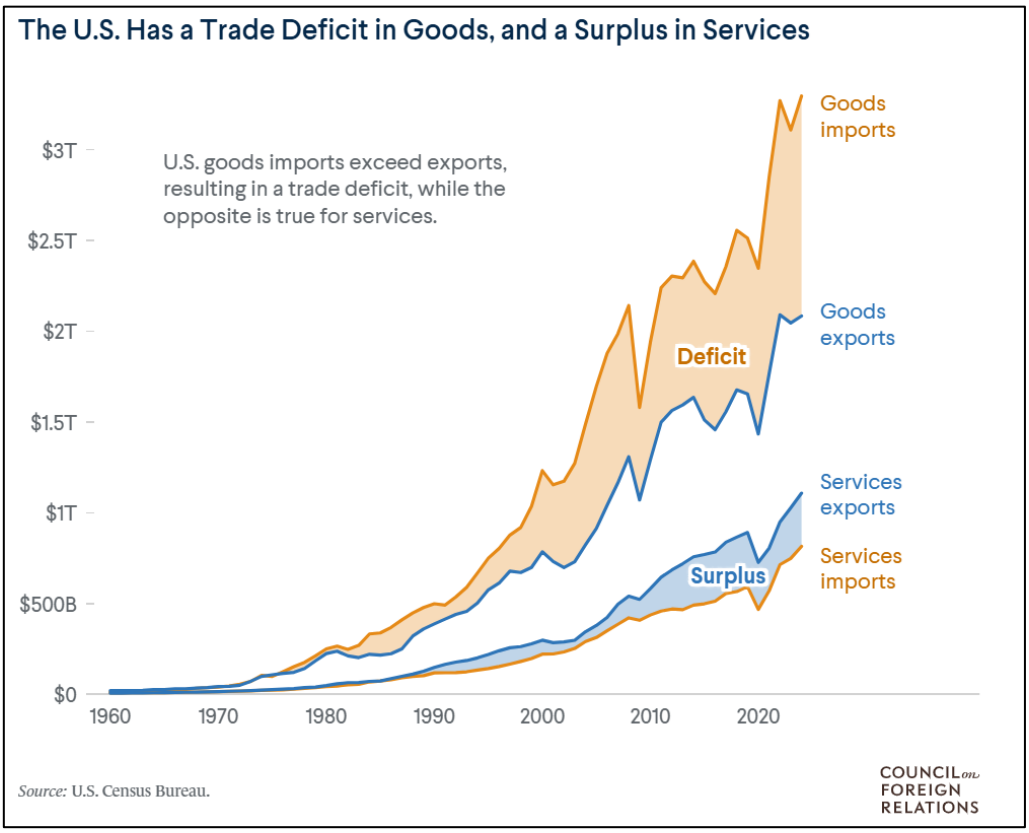

Figure 4: US' Goods Trade-Deficit VS Services Trade-Surplus [7]

Therefore, reducing the US' CA deficit requires reducing its fiscal deficit. Although the CA deficit is primarily a goods-trade deficit (only partially offset by the service-trade surplus, Figure 4), tariffs simply fail to address its structural cause (fiscal deficit).

In theory, tariffs artificially raise the price of imports to domestic consumers, reducing demand for imports. With falling imports, the bilateral trade deficit heals. Concurrently, price of domestic products appear cheaper, increasing their demand. Thus, domestic, inefficient industries are protected. Consequently, they are able to achieve economies of scale, and become export-oriented industries. With exports increasing, bilateral trade deficit also decreases, and may even become a surplus, thereby healing the CA deficit (which unfortunately, gets worsened by the unaddressed fiscal deficit).

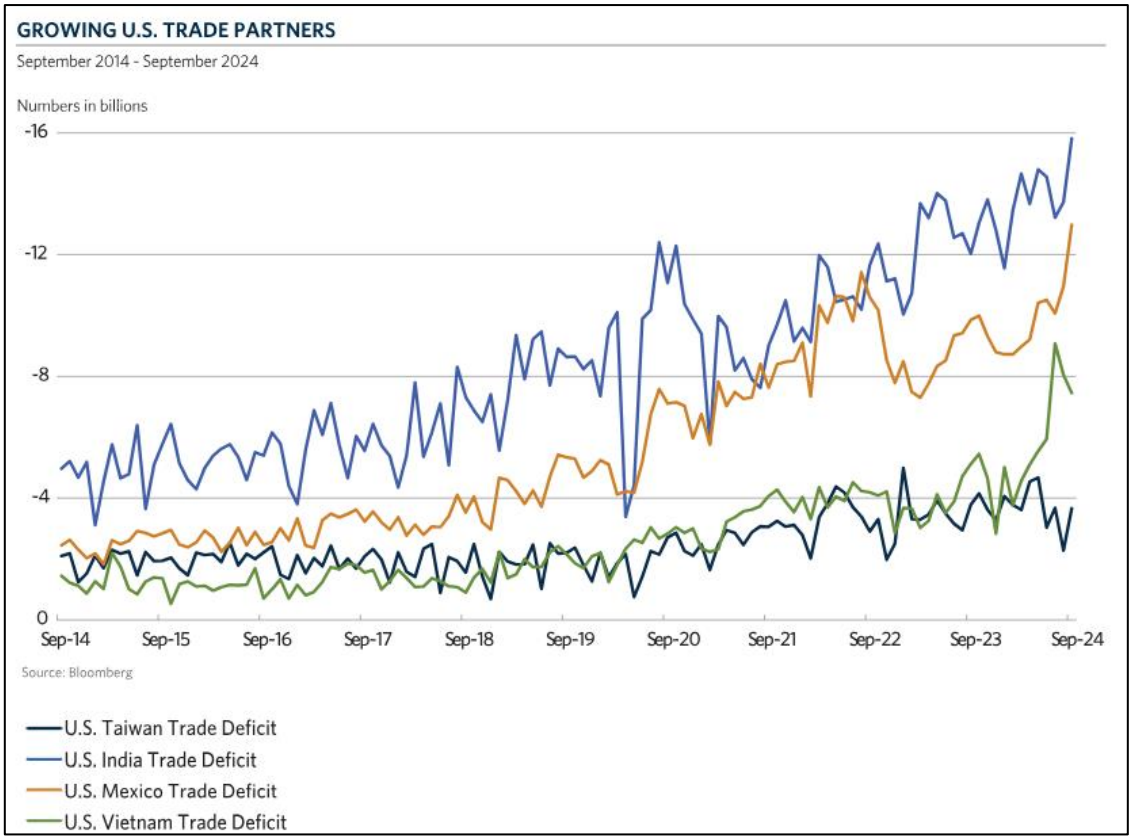

Figure 5: Trade Diversion in US following US-China Tariffs in 2018 [13]

However, two major caveats exist.

Firstly, demand for inputs remains strong under fiscal expansion policies. And despite tariff-protection, these domestic industries simply cannot expand capacity overnight to substitute fallen imports. Therefore, trade diversion occurs, shifting trade towards alternative suppliers which are less efficient (& more expensive) than China but still more efficient (& less expensive) than US' producers. For instance, following the 2018 tariffs on China, US trade deficits with Mexico, Vietnam, Taiwan and India worsened by 300%, 500%, 700% and 150% respectively (Figure 5) [13].

Secondly, trading partners may retaliate by imposing reciprocal tariffs on US. In 2018, China levied reciprocal tariffs on over $110 billion of US exports, causing soybean exports to China to collapse by 78% in a single year [14].

Overall, the US' trade deficit in goods worsened by 21% by the end of Trump's first term [15]. Therefore, these caveats reveal the tariff's inadequateness in addressing the CA deficit. Firstly, tariffs undermine export performance and worsen overall trade imbalance. Secondly, ongoing fiscal expansion sustains domestic demand, thereby encouraging trade diversion. Thus, US' trade composition is altered, where products are now being imported from costlier producers (either tariffed less, or are more efficient US producers).

3. Exchange Rate

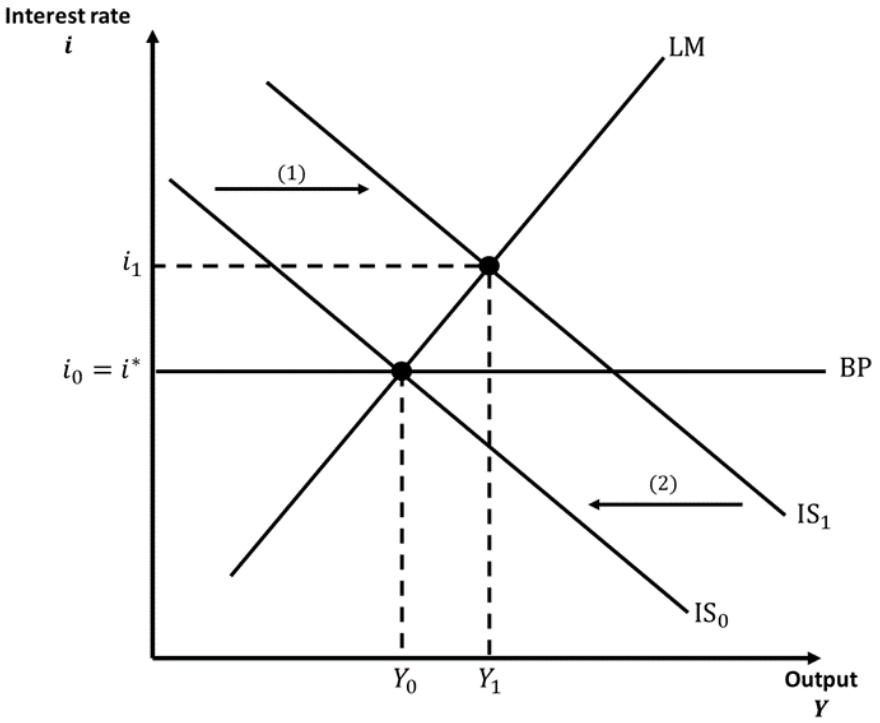

Figure 6: Mundell-Fleming Model of US' Economy

To start, fiscal expansion policies naturally appreciate the nation's currency (Figure 6). Under perfect capital mobility in the US, the BP curve is horizontal and initial domestic interest rate (i_0) is equal to world interest rate (i^*). Expansionary fiscal policies (like 2018's TCJA that reduced corporate taxes from 35% to 21% [16]) shift the IS curve to the right ($IS_0 \rightarrow IS_1$). In the short run, this raises both output ($Y_0 \rightarrow Y_1$) and domestic interest rate ($i_0 \rightarrow i_1$). With $i_1 > i^*$, large capital inflows occur, creating excess demand for USD, appreciating it. However, a stronger currency reduces net exports, shifting the IS curve to the left ($IS_1 \rightarrow IS_0$). Therefore, output falls ($Y_1 \rightarrow Y_0$), and domestic interest rate falls back ($i_1 \rightarrow i_0$), where $i_0 = i^*$.

Clearly, the fiscal policy is ineffective, because not only does output remain stagnant, but the economy is left with an appreciated currency, which hurts export-competitiveness, worsening the CA deficit.

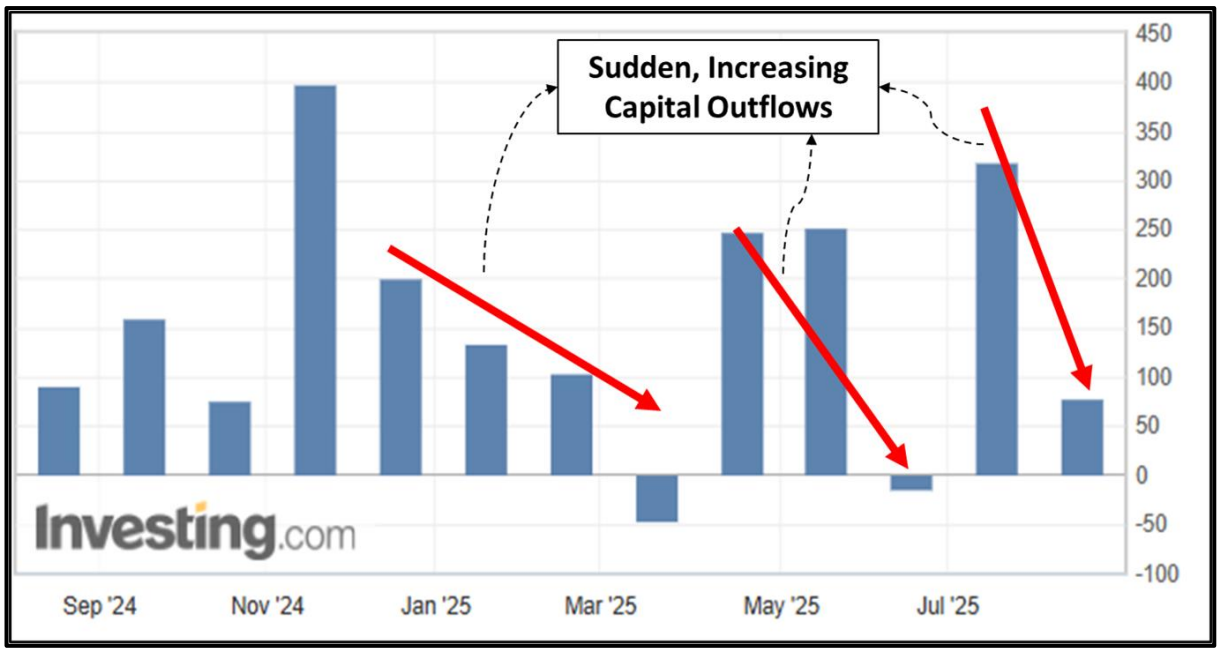

Figure 7: US' Net Capital Flow [17]

But such theoretical predictions may differ in reality, because currency movements are also influenced by investor confidence. For instance, the 2025 imposition of aggressive tariffs on over 90 countries introduced heavy policy uncertainty (discussed in Section 2). This eroded investor confidence, influencing large net capital outflows as investors sell their long-term securities (Figure 7). And since tariffs mostly cause trade diversion, demand for foreign currency sustains. Therefore, USD depreciated 7% within three months instead [18]. While some argue such currency depreciation improves export-competitiveness and heals the CA deficit, such effects are not immediate. The J-curve also depicts how in the short-run, trade balances worsen, as import volumes increase quicker than export volumes, temporarily worsening CA deficit. Additionally, currency devaluation increases the real value of US fiscal debt, worsens debt-servicing obligations, increasing opportunity cost for meaningful government expenditure (for instance, into protected industries). And such events will only exacerbate unless investor confidence restores.

4. Domestic Employment

One of the reasons the Trump administration implemented tariffs is to revive the US manufacturing industry. Tariffs increase the price of imports, encouraging consumers to switch to domestically-produced goods, thus increasing demand for local labour. Therefore, in theory, this should increase wages and employment in protected manufacturing industries like aluminium and steel.

However, the large fiscal deficit conflicts with this outcome. While expansionary fiscal policies such as lowering corporate taxes (TCJA) and industrial subsidies should create jobs, the prevailing fiscal deficit increases interest rate, thereby crowding out private investments, preventing job-creation, increasing structural unemployment [(19)].

Moreover, unpredictable tariff swings and trade retaliation creates uncertainty, discouraging firms from committing to long-term investments into manufacturing capacity. Consequently, one in four CFOs now prefer hiring temporary staff or investing in automation over expanding permanent staff in the US [(20)], reducing long-term employment opportunities.

Additionally, overall employment gains are limited due to the small size of protected industries relative to downstream industries that depend on them. Downstream industries rely heavily on imported intermediate and capital goods as inputs, which amount 55% of US imports in 2023-2024 [(21)]. Therefore, tariffs on these inputs increase production costs, which increases layoffs. For instance, for one job produced in US steel production, 80 jobs are lost in steel-using industries like construction and automobiles, leading to net unemployment [(22)].

Overall, while tariffs aim to increase domestic manufacturing employment, high fiscal debt, low investor confidence and dependence on imported inputs limit their effectiveness. Thus, net unemployment rises, with an expected drop of 200,000 to 300,000 jobs per annum in the labour market [(23)].

5. Conclusion

In conclusion, tariffs and persistent fiscal deficits conflict, resulting in unintended economic consequences.

To begin, CA deficits persist because tariffs fail to address their structural cause: fiscal deficits. Rather, tariffs merely distort trade composition through diversion to less efficient producers (tariffed less), reducing allocative efficiency and introducing additional, avoidable costs to the economy.

Furthermore, tariffs erode investor confidence, as they signal a potential trade war, causing currency depreciation that unfortunately increases real value of US debt, increasing opportunity cost of meaningful government spending. And finally, while tariffs may protect certain industries, higher borrowing costs due to prevailing fiscal deficits crowd out private investments. This, coupled with lower investor confidence, reduces investment into protected industries, thus job creation decreases, increasing structural unemployment.

In short, the fiscal deficit has negated any intended benefits of tariffs, worsening the US economic climate, creating an uncertain future. As Mark Carney, former Governor of the Bank of England, warned, the US relies heavily on "*the kindness of strangers*" to finance its fiscal deficit [(24)]. Yet, tariffs hinder such relations. And should external-financing cease, US may face a similar climate as Portugal's 2010-2014 debt crisis, where abrupt capital outflows caused deep recessions, forced austerity measures and a loss of economic sovereignty [(25)].

But in the end, consumers face the largest burden. They face higher unemployment, higher costs of living, only to be financed by higher costs of borrowing. Thus, without addressing the fiscal deficits and re-evaluating the tariffs, US risks economic instability, increased inequality and falling standards of living.

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