CENTER FOR GLOBAL DEVELOPMENT

CGD NOTE 379 | MARCH 2025

The Financial Realities of the US Trade Deficit that Tariffs Can't Change

Liliana Rojas-Suarez and Ignacio Albe

It's been repeated time and again: The US trade deficit stems from a persistent savings-investment gap. Without closing that gap, the deficit won't shrink. Tariffs may reduce the bilateral trade deficit with one country, but they increase the trade deficits with others—like pressing on one part of a balloon only to see another part expand. Crucially, narrowing the overall US trade deficit (reducing the investment-savings gap) may not be achieved through US policies alone; the international capital markets play a decisive role. Here is how it works, with the data to back it up.

The US current account deficit

While economists disagree on the central factors explaining key macroeconomic aggregates such as inflation or economic growth, they all acknowledge the power of accounting identities. One key identity is that the current account balance (CA) must equal the difference between national savings (S) and investment (I):

$$(1) \qquad CA = S - I$$

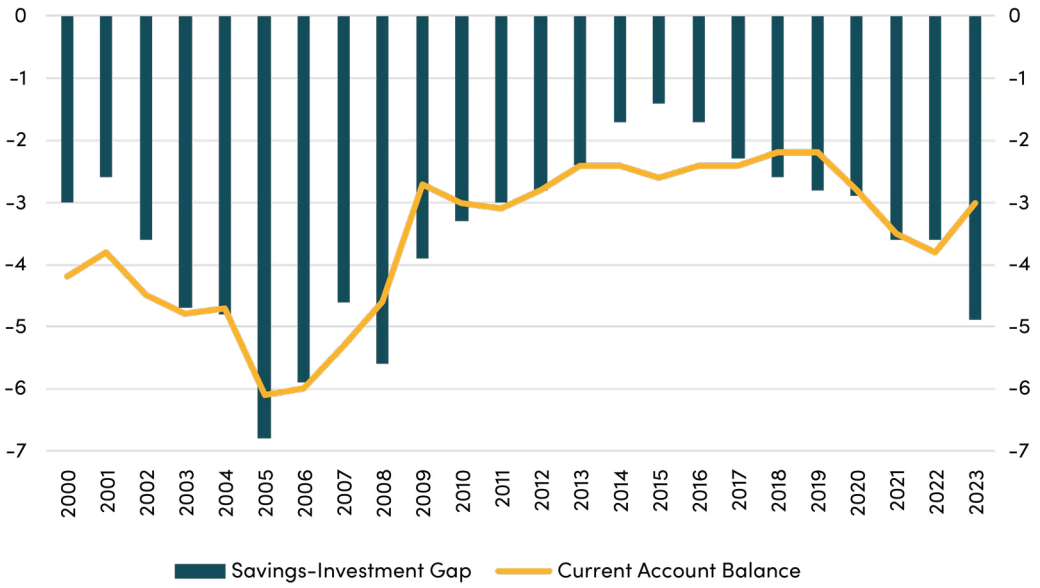
For a refresher on the basics of macroeconomic accounting, see the appendix.

The US current account balance has remained negative for the last 25 years (Figure 1). In fact, the current account has been in deficit for nearly every year since the 1980s. Figure 1 also displays the savings-investment gap as a percentage of GDP, using International Monetary Fund (IMF) data from the Bureau of Economic Analysis. While statistical discrepancies prevent a perfect match between the current account balance and the savings-investment gap in certain years, the broader pattern is clear. As the IMF noted in its most recent Article IV report for the US, *"there is a need reconcile the*

saving-investment balance in the national accounts with the current account balance in the balance of payments as the discrepancy has widened significantly." Nonetheless, it is apparent that when the savings-investment gap has widened, current account deficits have also been larger. This trend is particularly evident in the years following the COVID-19 pandemic, when the gap increased alongside a deterioration in the current account balance.

These are simply observed facts—they do not, in themselves, imply that a current account deficit or its size is necessarily a *bad* economic outcome for the US. We'll get to that issue below.

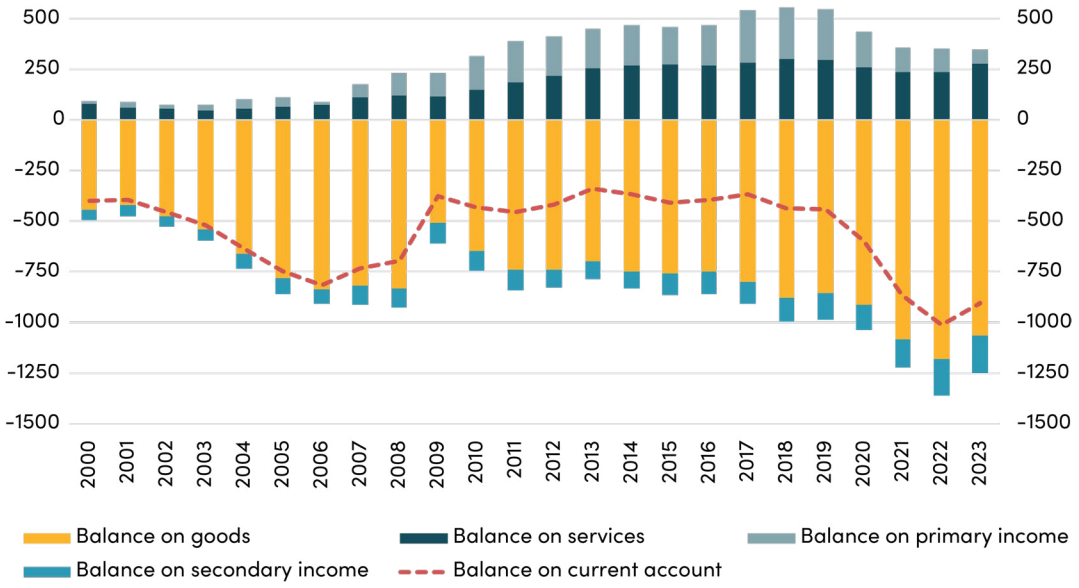
Figure 1. The persistent savings-investment gap in the US (% of GDP)



Source: IMF Article IV (various years) based on data from the Bureau of Economic Analysis.

Balance of payments data also shows that the lion's share of the current account deficit is explained by the trade balance. More specifically, the trade deficit in goods dominates the overall picture, as the service balance has remained in surplus (the US is a net exporter of services). Furthermore, the relatively smaller net factor payment, or net primary income balance as it is called in US national accounts, has exhibited surpluses. The secondary income balance, which is mostly composed of remittances, is also small but negative, as expected, since there are more transfers sent abroad than received. (Figure 2)

Figure 2. The trade balance of goods dominates the US current account balance (US $ billion)



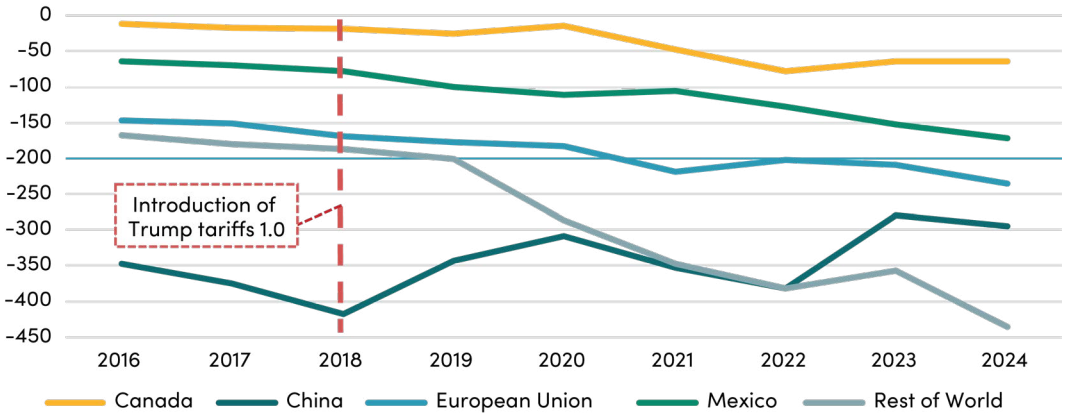
Source: Calculations based on data extracted from the US Bureau of Economic Analysis, "Table 1.2. U.S. International Transactions, Expanded Detail."

Enter tariffs

It is well documented that the tariffs imposed on China for a large list of goods, during the first Trump administration did not reduce the US trade deficit. As Figure 1 shows, the negative savings-investment gap has widened since 2018—when the first round of Trump tariffs was implemented—and so has the trade deficit (Figure 2). Instead of shrinking the deficit, the tariffs led to a shift in the relative contribution of different trading partners to the US trade imbalance.

Figure 3 illustrates the recent evolution of the US bilateral trade deficit in goods with major trading partners (China, Canada, Mexico, the European Union) and the rest of the world. Two important observations emerge: First, the improved trade balance (reduction in the trade deficit) with China following the imposition of tariffs has been offset by the worsening trade deficit with other partners (the balloon analogy: squeeze one side and the other side compensates).

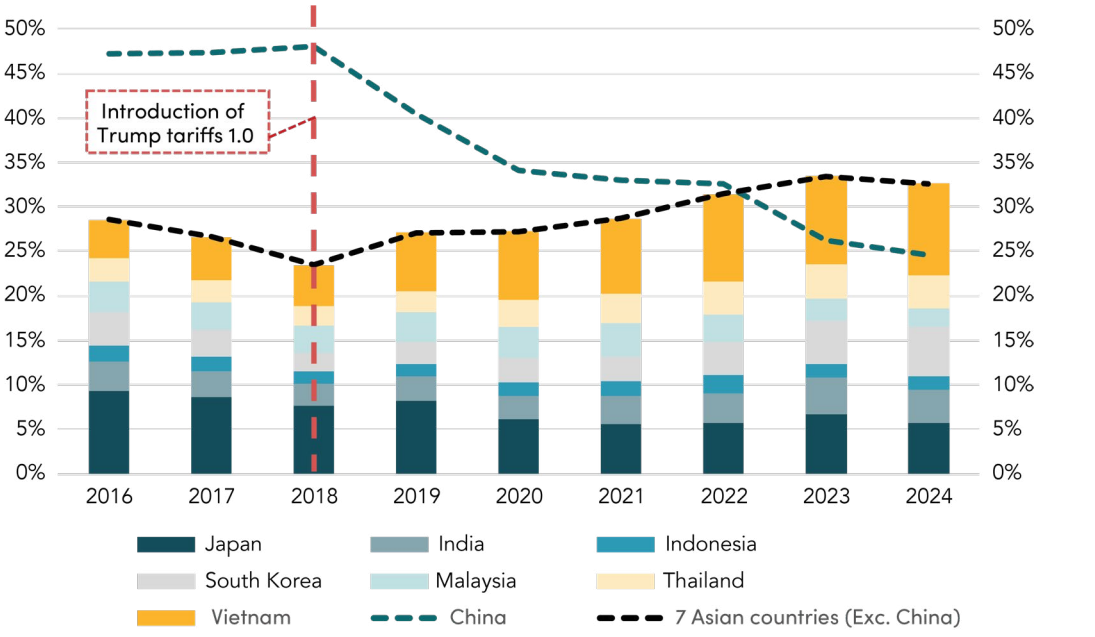
Figure 3. Shift in U.S. trade partner composition after 2018-19 tariffs (bilateral goods trade deficits—billion USD)



Source: Calculated with data from the US Census Bureau.

The second observation is that the larger deterioration in the US bilateral trade deficit has occurred with the rest of the world—notably, the major Asian countries. As shown in Figure 4, Vietnam leads, with its relative importance increasing, especially since 2019, after the tariffs on China were imposed. South Korea, Thailand, and India have also gained relative importance, while Japan's share has decreased. By end-2024 the share of US bilateral trade deficit with non-China Asian countries surpassed the share of the US bilateral trade deficit with China.

Figure 4. The increasing importance of Asia (excluding China) as US trading partner (bilateral US trade deficits in goods as percentage of total US trade deficit)



Source: Calculations based on data from the US Census Bureau on trade in goods.

The graphs above show that the iron law of the national account identities is at work: so long as the US savings-investment gap remains large, tariffs on one group of countries will merely shift the bilateral US trade deficit to others.

But, just how problematic are persistent trade deficits?

To answer this question, we need one more identity. While the current account can be calculated from the national accounts, it is also defined within the balance of payments framework. The current account is the negative of net capital flows because, by definition, the balance of payments must sum to zero. Any deficit (or surplus) in the current account is exactly offset by an equivalent surplus (or deficit) in capital flows.

(2) $CA = -Net\ flows\ of\ capital$

Since the US runs persistent current account deficits, this implies that it must also have sustained net capital inflows. However, as with the national account identity, the balance of payments identity doesn't have any implications about causality and thus, it can be interpreted in two ways:

1. **Trade-driven view:** A trade deficit (excess imports over exports) necessitates borrowing from abroad to finance the imbalance, resulting in capital inflows. Under this view, the trade balance is the primary driver of the balance of payments.

2. **Capital-driven view:** International capital markets determine the flow of funds first. If foreign investors channel more capital into US assets than Americans invest abroad, net capital inflows increase, driving up demand for dollars. This leads to currency appreciation, making imports cheaper and exports less competitive, widening the trade deficit.

While certainly both views play a role in the balance of payments flows, the second view is most compelling as a dominant factor. Pettis and others argue that the first interpretation was more relevant when international capital markets were less developed and capital flows were largely tied to trade finance. Today, cross-border capital movements involve a range of actors—corporations engaging in foreign direct investment, banks, pension funds and other institutional investors, sovereign wealth funds and central banks accumulating foreign exchange reserves. **If the Trump administration succeeds in attracting large amount of capital inflows, the most likely outcome is a stronger dollar and even larger trade and current account deficits.**

Regardless of the preferred interpretation, whether trade and current deficits and, therefore, positive net inflows of capital are beneficial or problematic depends on how the funds are used. In the US, productive investment projects often attract foreign financing. If these investments generate

strong returns and support economic growth, the increase in indebtedness from abroad may not be a concern and the current account deficit can remain sustainable. Historically, there are multiple examples of periods when widening current account deficits in the US have coincided with robust economic expansion. Thus, assessing the implications of US trade and current account deficits requires understanding how incoming capital is allocated. These deficits are not inherently harmful, but their sustainability depends on whether the funds support productive investments or merely finance excess consumption.

Can US policies alone effectively control trade imbalances?

Finally, can US policymakers reduce the trade and current account deficits by cutting the fiscal deficit? The discussion above suggests that this may not necessarily be the case. It depends on how domestic and foreign investors react to growth expectations resulting from this policy. Let's explore this a bit.

Equate (1) and (2), to get:

(3) $S - I = -$ *Net inflows of capital*

A reduction in the fiscal deficit will lower the trade deficit only if it effectively narrows the savings-investment gap by reducing net inflows of capital. The standard textbook mechanism suggests that lower fiscal deficits lead to reduced interest rates, discouraging capital inflows and thereby improving the trade balance. However, if fiscal consolidation is *perceived* as pro-investment policy—especially when paired with deregulatory policies—capital inflows might actually increase, funding higher domestic investment. In this case, the savings-investment gap could widen, further expanding the trade deficit.

Parting thought

From the perspective of the US trade and current account balances, tariffs are a distraction. Given the depth of the US capital markets, investor sentiment and capital flows play a more decisive role in shaping external balances than trade policy. That said, tariffs are not without consequences. They could reignite inflationary pressures and disrupt global trade dynamics in unpredictable ways. But that is a topic for another discussion.

Appendix. Why the current account equals the savings-investment gap: Basic macroeconomic accounting

It's straightforward, just two identities that define the national accounts: specifically, gross domestic product (GDP) and gross national product (GNP). While GDP refers to the value of all goods and services produced within a country's borders, regardless of whether the producers are domestic or foreign, GNP refers to all income (domestic and foreign) earned by residents and firms of that country, regardless of where they are located.

(i) $GDP = C + I + G + X - M$

(ii) $GNP = GDP + NFP$

The first identity shows that a country's total domestic production of goods and services (GDP) is equal to its various uses. These uses can be broken down into consumption by the private sector (C), government spending (G), total investment—both private and public (I). and net demand from abroad, which is defined as exports (X) minus imports (M). X-M represents, of course, the country's trade balance.

The second identity defines the concept of gross national product (GNP) as the sum of GDP and net factor payments (NFP), where NFP is the income earned by residents from foreign investments (such as dividends and interest) minus the income paid to foreigners for their investments in the country. A positive NFP indicates that the country is receiving more income from its investments abroad than it is paying to foreign investors holding the country's external liabilities.

Noting that the current account balance (CA) is, by definition, the sum of the trade balance and net factor payments: CA = X – M + NFP, and substituting identity (i) into (ii), we obtain:

(iii) $CA = GNP - (C + G + I)$

Finally, national savings (S) is the portion of national income that is not consumed by either the private or public sector. This means national savings equals GNP minus (C + G), leading us to the identity: the current account is the difference between national savings and investment.

LILIANA ROJAS-SUAREZ is the director of the Latin America Initiative and a senior fellow at the Center for Global Development.

IGNACIO ALBE is a research assistant at the Center for Global Development.

Suggested citation:
Liliana Rojas-Suarez and Ignacio Albe. 2025. "The Financial Realities of the US Trade Deficit that Tariffs Can't Change." CGD Note 379. Washington, DC: Center for Global Development. https://www.cgdev.org/publication/financial-realities-us-trade-deficit-tariffs-cant-change