Flash Economics

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Is a depreciation of the dollar good for the United States? Would it wipe out its external deficit?

Donald Trump's advisers clearly believe that a depreciation of the dollar would improve the US trade balance.

But the problem is that domestic production is a poor substitute for imports, just as overseas production is a poor substitute for exports. The volume of imports would fall only slightly, and the volume of exports would increase only slightly in response to a depreciation of the dollar. On the other hand, the price of imports would rise sharply, and the cost of imports would increase, with the trade balance still more or less showing the same deficit. The same reasoning can be applied to tariffs. If there is little substitutability between imports and domestic production in the United States, the application of tariffs will reduce the volume of imports only slightly and increase their price considerably, thus increasing the cost of imports for the United States.

In reality, in such an environment of low substitutability between domestic production in the United States and production in foreign countries, it is a strong dollar that is optimal.

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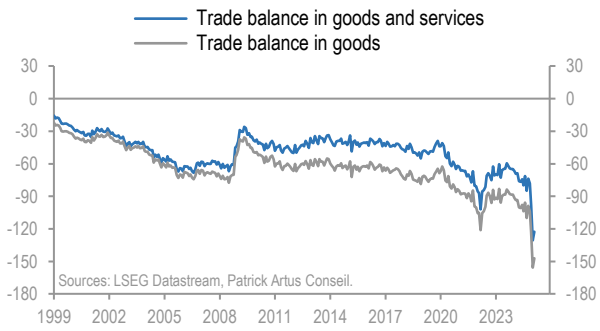
Low substitutability between US production and production in other countries

Donald Trump's advisers clearly believe in the existence of a simple economic mechanism: **a depreciation of the dollar** (**Chart 1**) **would wipe out the US trade deficit** (**Chart 2**).

Chart 1
United States: Real effective exchange rate (1999.M1 = 100)



Chart 2
United States: Trade balance in goods and services (monthly data, USD bn)



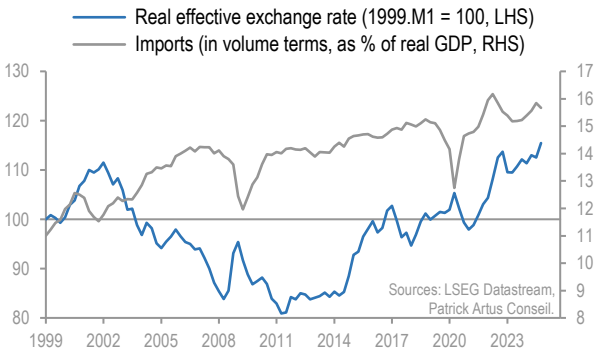
But in reality, this link between the dollar exchange rate and the US trade balance does not exist because of:

- **The low substitutability between US imports and US domestic production**; and
- **The low substitutability between US exports and production in other countries**.

As can be seen, **variations in the real exchange rate of the dollar have little impact:**

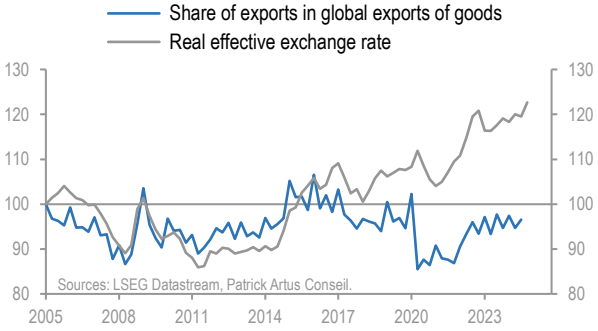
- **on the weight of US imports in real GDP** (**Chart 3**);

Chart 3
United States : imports and real effective exchange rate



- **on the weight of US export volumes in world trade** (**Chart 4**).

Chart 4
United States: Share of exports in global exports of goods and real effective exchange rate (2005.Q1 = 100)



From 2004 to 2016, the dollar is weak, but imports in volume relative to GDP are more or less stable, and exports in volume relative to world trade remain low.

From 2017 to 2025, the dollar is strong, but imports in volume relative to GDP are not growing any faster than before, and exports in volume relative to world trade are falling, but only slightly.

What is the effect of a depreciation of the dollar or an increase in tariffs if substitutability between US production and production in other countries is poor?

If production in other countries and production in the United States are poor substitutes:

- **a depreciation of the dollar exchange rate** (real and nominal) has little effect on the volume of imports or the volume of exports; **its main impact being a rise in the dollar price of imports** and, to a lesser extent, to foster a rise in the dollar price of exports, since the foreign currency price of US exports is reduced by the depreciation of the dollar;
- since imports clearly exceed exports (**Chart 5a/b**), a **depreciation of the dollar unambiguously increases the net cost of US imports**;

Chart 5A
United States: Exports and imports of goods and services (monthly, USD bn)



Chart 5B
United States: Exports and imports of goods (monthly, USD bn)



- an increase in tariffs on imports has little effect on the volume of imports and its main impact is a rise in the price of imports, thus increasing the cost of US imports, with a minor impact on the trade deficit.

Summary: in reality, it is a strong dollar that is optimal

Since US imports and domestic production are poor substitutes, on the one hand, and US exports and production in other countries are equally poor substitutes, on the other, depreciating the dollar does little to improve US foreign trade in volume terms and does not improve the US trade balance.

In reality, in the US situation, it is an increase in the dollar exchange rate that is optimal, as it reduces the cost of imports.

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