Flash
Economics

N° 79
July 4, 2025

The risk that the United States' external deficit may become unfinanceable

The United States’ external deficit is currently financed through the purchase of dollar-denominated assets, primarily public securities, by countries such as Japan, the Eurozone, the United Kingdom, and the United Arab Emirates.

However, these purchases of dollar assets could decline significantly in the future due to:

- the anticipated depreciation of the U.S. dollar;
- the fall in oil prices, resulting from increasing oil overproduction, and consequently the fall in revenues of oil-exporting countries;
- the rise in long-term interest rates in Japan, driven by higher inflation feeding through into interest rates, leading Japanese investors to substitute Japanese bonds for foreign bonds they currently hold;
- the perceived risk that American technology stocks are overvalued, with excessively high valuations prompting a shift away from US equities in favour of, in particular, European equities;
- the continued rise in the United States' public debt ratio.

If the US external deficit becomes difficult to finance, a sharp decline in domestic demand may follow, caused by falling stock market indices (with the associated negative wealth effect) and a rise in long-term interest rates.

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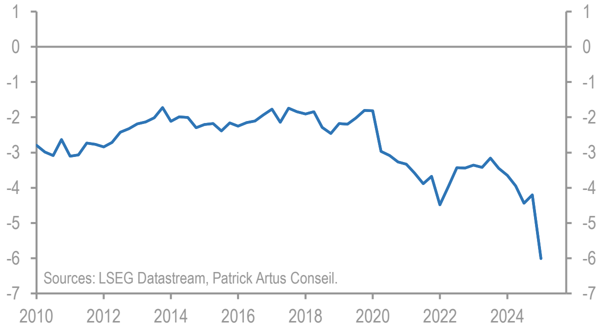
How is the United States' external deficit financed?

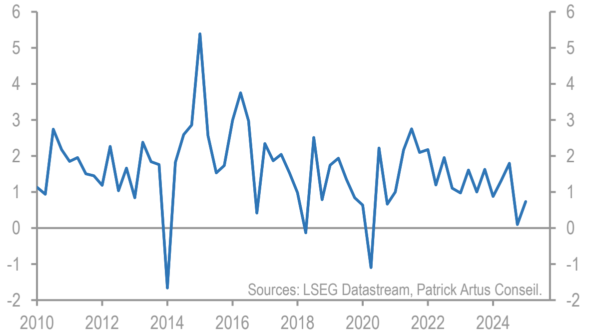
The United States has **a significant current account deficit** (**Chart 1**).

Chart 1
United States: Current account balance
(as % of nominal GDP)



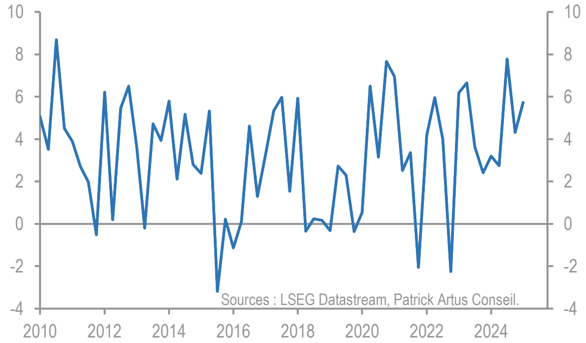
This deficit is financed **by purchases of American assets by non-residents**: direct investment by companies (**Chart 2**), and purchases of shares and bonds (**Chart 3**).

Chart 2
United States: Direct investment inflows*
(as % of nominal GDP)



(*) Direct investment inflows are capital inflows leading to an increase in liabilities (in this case for the United States) and therefore have a positive sign.

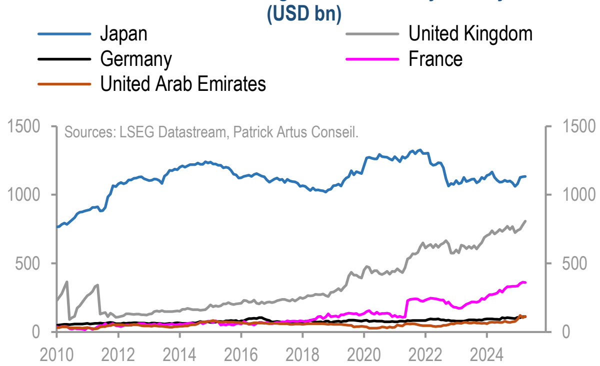
Chart 3
United States: Portfolio investment inflows*
(as % of nominal GDP)



(*) Direct investment inflows are capital inflows leading to an increase in liabilities (in this case for the United States) and therefore have a positive sign.

We know **the breakdown of countries investing in US Treasury debt**: these are mainly Japan, European countries, the United Kingdom, and the United Arab Emirates (**Chart 4**).

Chart 4
United States: Holdings of Treasuries by country
(USD bn)



The risk of a financing problem for the US external deficit

A financing problem for the US external deficit could stem from several causes:

1. **The expectation of continued depreciation of the U.S. dollar** (**Charts 5a/5b**), either resulting from a deliberate attempt to reduce the U.S. dollar's role as a reserve currency, or from a shift to a more expansionary monetary policy.

Chart 5A
Euro/dollar exchange rate (EUR 1 = USD...)

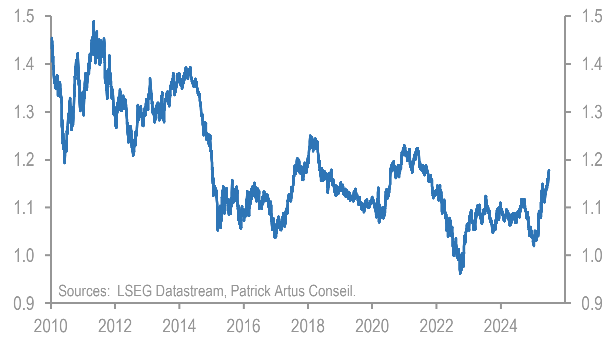
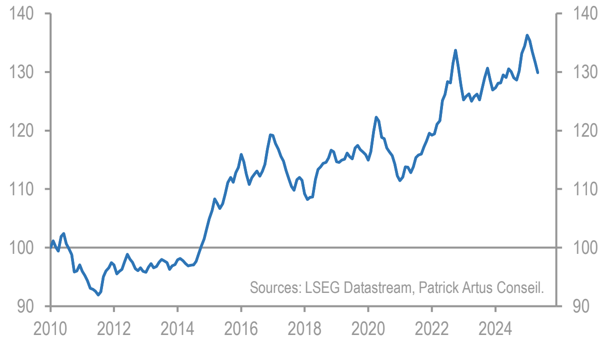


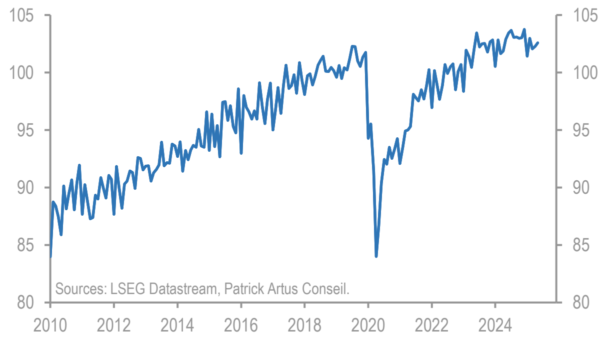
Chart 5B
United States: Real effective exchange rate (2010.M1 = 100)



2. **The decline in oil prices** (**Chart 6**), caused by oversupply amid stagnating global oil demand (**Chart 7**), which would eliminate the current account surpluses of oil-producing countries.

Chart 6
Oil price (Brent, $/bbl)

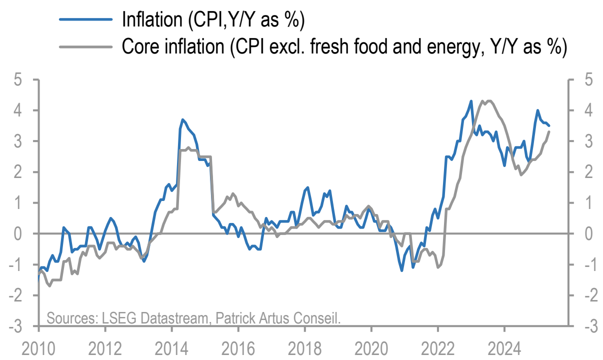
Chart 7
World: Oil consumption (million bbl/day)



3. **The rise in long-term interest rates in Japan**, linked to the currently high inflation observed in Japan (**Charts 8/9**), which will encourage Japanese bondholders to substitute Japanese bonds for US bonds in their portfolios.

Chart 8
Japan: Interest rate on 10-year government bonds (as %)

Chart 9
Japan: Inflation and core inflation (as %)



4. **A growing perception among investors that US tech stocks are overvalued** (**Charts 10/11**), which would discourage them from holding American equities, possibly in favour of European equities.

Chart 10
Stock index of the Magnificent Seven (01.06.2012 = 100)

Chart 11
NASDAQ: P/E ratio

5. **The anticipation of a sustained rise in US public debt**, due to the tax cuts enacted by the Trump administration and the large public deficits they imply (**Charts 12/13**), which could reduce foreign demand for US Treasuries.

Chart 12
United States: Public debt (as % of nominal GDP)

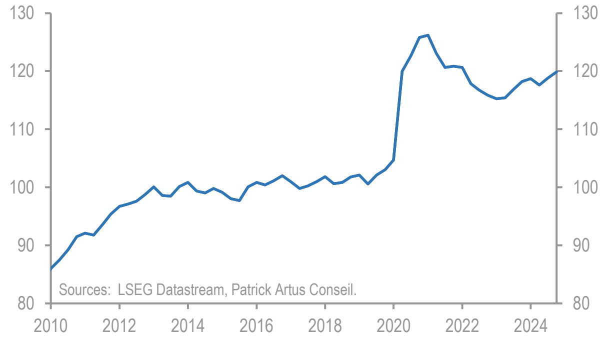
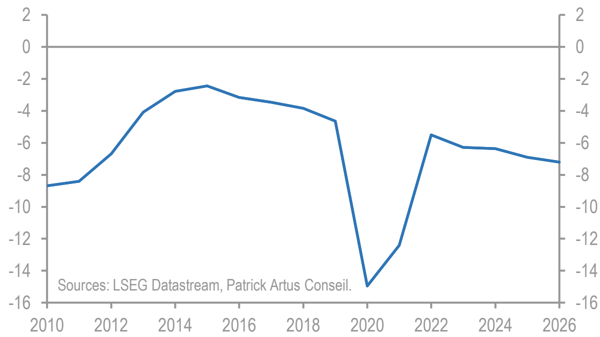


Chart 13
United States: Budget deficit (as % of nominal GDP)



Summary: What are the consequences if the United States' external deficit becomes difficult to finance?

We have seen that there is a real risk that the United States' external deficit may become difficult to finance due to the anticipated depreciation of the U.S. dollar, the expected decline in oil prices, increased investor appetite for Japanese debt, concerns about the overvaluation of US technology stocks, and the sharp rise in US public debt.

If this financing difficulty materialises, a necessary contraction in domestic demand would follow, driven by falling stock market indices (with the associated negative wealth effect) and rising long-term interest rates.

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