

Peterson Institute for International Economics

The changing dollar regime: An update

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[00:05:22.01] - Adam S. Posen

Hello everyone, and welcome back to the Peterson Institute for International Economics. I'm Adam Posen, the Institute's president, and we're delighted this IMF World Bank Annual Meetings week to pick up conversations with friends and colleagues from around the world and to pick up topics which we've all been working on busily since the last time we convened. Some of you may recall that last April around the spring meetings, we held an event here with Maury Obstfeld, Markus Brunnermeier, Warwick McKibbin, and myself talking about decentering the dollar. And I've been emphasizing that term uphill against other terms because I think it captures what we're concerned about, that it's not that the dollar is going to fall some huge amount, the dollar's in crisis, but that the centrality of the dollar and the many important benefits for both the US and the world economy that went with having a strong central currency and a strong insurance provider, if I may, have been eroded and are being somewhat replaced. And then the question is, do other things emerge, obviously? And we'd like to think that amidst all the discussion in the private sector that sometimes gets a little short-term or florid about this, and all the discussion in the public sector, which for good understandable reasons in public is not very interesting.

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We hope we provide a forum and a service and a convening. And so in that spirit, we are having today's event, The Changing Dollar Regime: An Update. Before I introduce today's event, I just want to put it in the context of other things we're doing on this front at this time. Many of you, I hope, are aware that tomorrow We are moving to some more frank and thoughtful current and former officials on Europe in a changing international monetary system with remarks by Agnès Bénassy-Quéré of the Banque de France, Klaas Knot, the previous president of the FSB, chair of the FSB and president of the Dutch Central Bank, Signe Krogstrup, the governor of the Danish National Bank, Olli Rehn, the governor of the Bank of Finland, and our colleague, our former colleague, Ángel Ubide, who with Olivier Blanchard is advocating for the spread and adoption of euro bonds. So tomorrow I think provides a nice bookend to today. I do want to say

for the record, especially since we have a distinguished European, Moritz Schularick, with us today, speaking today, that we are actively in the market for European officials and academics who want to speak on these issues.

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I've been trying. This is not deliberate omission. Maybe deliberate omission on the other end. But anyway, let the word go out. This isn't just about Europeans' responses. This is about Asian responses. This is about private sector responses. This is about global responses. I also just want to highlight two future events after this week that I think will be of interest to this crowd. The first, on Wednesday, October 29th, I guess 2 weeks from yesterday, we have the privilege of having 2 senators, senior senators from the US, who are willing to talk skeptically about the trade policy that is being pursued by the Trump administration, and they're from different parties: Senator Rand Paul and Senator Tim Kaine. This is a not unique, but rare event. And so we hope many of you will join us online, if not in person, for that. And not finally, but the other event I wish to highlight, which is very important, is David Wilcox and I, with John Cochran of the Hoover Institution, have convened an event on central bank independence in practice. As some of you may be aware, there is some reconsideration about the extent and benefits of central bank independence in the U.S. We are taking very seriously some of the practical questions that come out of that in terms of how you define what's monetary versus financial, what is the process of accountability in the U.S. system, what is the more recent record on benefits and costs potentially of central bank independence.

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I think in the end we will still think it's a good idea, but I'm not being cute. We are— and it's part of the reason David and I have benefited from having John Cochrane involved— we are going a bigger tent to talk more seriously and openly about this issue, and we hope to provide people in Congress and the courts here with a better understanding going forward. That is on October 31st, a scary topic for Halloween. Um, speakers include Larry Summers, Rich Clarida, Charlie Evans, Roger Ferguson, Randy Kroszner, Dan Tarullo, Paul Tucker, Carolyn Wilkins. So we hope all of you will either join us in person or online for that and get the message out. With my advertising job done, let me turn back to today's exciting panel, The Changing Dollar Regime: An Update. We're delighted to have speaking today Maury Obstfeld, Moritz Schularick, and Joe Gagnon. Just to briefly recap, Maury— and I think that's the order in which we're speaking— Maury was, of course, chief economist at the IMF, and prior to that, Professor at the University of California at Berkeley and one of the leading— remains one of the leading international economists in the world.

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We all learned from his textbook, we all learned from his papers, we all learned from talking to him. And he is invaluable as the Siegfried Burgenstein Senior Fellow here at Peterson, as someone who truly does bridge trade and macro and in a way that almost nobody does. And he's a wonderful colleague. So Maury will be picking up on the remarks he made in April and on his excellent Crockett lecture at the BIS annual meeting in July or August in the summer, which is available on our and the BIS website. Moritz Schuller is a distinguished rising star. I guess now he's already risen. He's younger than me, so I call it rising, but he's already well risen. Moritz is the president of the Kiel Institute for the World Economy and has restored that noble think tank in Germany and Europe to its critical position in German and European economic policy debates. He's done it through a combination of institutional leadership and intellectual leadership. He also teaches at a minor place called Sciences Po. And in particular, he has shown real willingness to push issues of what he calls geoeconomics at the intersection of national security and economics in both rigorous research and practical terms.

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He's previously been a professor of macroeconomics at the University of Bonn and holds a number of distinguished academic credentials. He was a recipient of the 2022 Leibniz Prize. Germany's most prestigious research prize. Final speaker today is my friend and longtime colleague Joseph Gagnon, a senior fellow here at the Peterson Institute since 2009. Time flies when you're having fun. Joe had a very distinguished career, for those who know, as one of the most influential, dependable, and free-thinking senior economists at the Federal Reserve Board in the Division of International Finance. Stepped up enormously around discussions of the savings glut and had an influence with Ben Bernanke when that idea came out. And then both at the Division of International Affairs and the Division of Monetary Affairs played a key role in the design of QE1 and response to the global financial crisis. Since, she's also served at the US Treasury Department and taught at the Haas School at Berkeley. Since joining the Institute, he's made a number of contributions, including to academic journals and Peterson's publications. The three I would highlight most is that he and Fred Bergsten came up with the scheme of how to assess currency manipulation on the part of the US Treasury that is still used, although not as rigorously as it should be, to this day.

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He has done recurring work on the sustainability of the U.S. external deficits and the role of the dollar, and he'll be speaking about some of his latest work on that today. And he also continues to produce insightful work on inflation and monetary policy, and in particular, he'll be talking today about some joint work with Tam Bayoumi, who many of you know. And— but I also want

to flag a recent paper he's done with Steve Kamen, another former senior Fed official, on the lasting impact of recent memories of inflation on inflation expectations. Thank you for letting me go on a while. This is a panel I'm very proud of. I'm very glad we get to host them, and I see they have a deservedly large audience and senior audience in the room. We look forward to engaging with all of you and worldwide. With that, Maury, can you start us off on the changing dollar regime?

[00:15:51.46] - Maurice Obstfeld

Okay, thank you and, uh, and welcome, uh, everyone.

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Uh, U.S.

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institutions have been critical in underpinning, uh, the dollar's role in bringing it to the point where it is in effect, the world's, uh, global currency. Uh, what institutions are at stake? Deep and open financial and product markets, commitment to multilateralism including credibility in the security sphere, uh, strong monetary and fiscal frameworks which have generally produced fiscal and price stability a commitment to limited government intervention in the marketplace, and finally, the rule of law. All of these underpin the dollar's central role. Uh, it's fair to say they're all under threat in the current political environment in the U.S., and, um, I have to say, sadly, the U.S. serves as an example for the rest of the world. So I think, uh, if you're abroad You can't be too complacent about what is happening now. U.S. policy is being driven by a grievance narrative. It's a narrative that trade has been unfair to the U.S. It's been a cause of trade deficits and manufacturing decline. There's a narrative that global capital markets have operated against the U.S. Interest. In fact, the very primacy of the dollar, its status as the global currency, is viewed by some as a disadvantage to the US by giving a stronger dollar, which may lead to bigger trade deficits, a smaller manufacturing sector.

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There are unfair burdens, it is claimed, of expensive foreign security commitments. And here I would include, uh, aid to lower-income countries, which in many ways do bolster regional and, I believe, global security. Now, if you look back over the entire post-war period, these types of concerns are, are not new. Concerns over the U.S. balance of payments go back to the 1960s, uh, uh, of course, but the current U.S. zero-sum approach to redressing them is very new, and so is the routine use of tariffs for geopolitical coercion, often going far beyond trade-related

issues. We've seen a big policy pivot in the U.S. so far in the Trump administration. Interesting to look at how this is done in terms of two of the key metrics that underlie the grievance narrative. One is the trade balance in goods, which seems to be the focus of the complaints. Another is manufacturing employment. Now, Joe is going to talk a lot more about the dollar's position in the markets and the US trade imbalance. It's just interesting to look at the blue line here, and what we see is that it's, it's kind of hard to see what is going on.

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I don't think any clear trend has been established. These are nominal numbers, of course, so we've had growth, we've had inflation, you have to take that into account. But we saw a huge trade disruption in the run-up to the Trump administration and in its early months as importers tried to front-run the tariffs. A lot of instability making it very hard to ascertain where we, we are in trade balance adjustments what effect the tariffs are having. The record is clearer on manufacturing employment, though again, you know, time will tell. But we did see something of a recovery here starting at the end of 2024, and this has come to an end and reversed with manufacturing employment falling. So if the goal was to restore this. We're not, we're not seeing it yet. I would argue that the international monetary and financial system is now at a crossroads, and this was the theme of my lecture at the BIS. The administration's policies are threatening to undermine U.S. global power as much as they might be designed to do the opposite. Hard power and soft power And I believe that not only are trade markets being fragmented, financial markets may be on the way to that fate as well.

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What are the phenomena we see? Tariffs and their coercive deployment, a possible pullback from international regulatory cooperation seems inevitable. We don't know how that will work out, but the signs are not good. I would argue that there's a risk of capital controls, inflow controls or outflow controls. These may be related to trade balance adjustment, to financial repression, but especially so if trade deficits remain high. The Genius Act is setting the stage for a proliferation of lightly regulated stablecoins. Pegged to the dollar coming from the US. This has the potential to spark reactions in countries that don't want to see their financial stability potentially compromised or give up monetary sovereignty. I think ultimately these are a mechanism for fragmentation rather than integration of the world payment system. Of course, we see the US providing— or retreating from providing key public goods that is provided. Adam's piece in Foreign Affairs looked at the insurance role of the US for the global commons. That is something that the US seems not interested in anymore. And of course, as Adam mentioned just now, pressures on the Fed pressures on central bank independence certainly threaten to undermine the position of the dollar and destabilize the system.

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Uh, we should not ignore fiscal indiscipline and the real risk that the U.S. moves into fiscal dominance. When, um, the president talks about why interest rates need to be lower in the U.S., often the theme is that, uh, it's about financing the deficit at lower cost. So there's a general assault on norms and the domestic rule of law. You know, as far as the fiscal deficit is concerned, I think the US may face a difficult situation going forward. There are various forecasts out there. Probably we're looking at over a 10-year horizon, \$4 trillion more of borrowing than was true at the beginning of the year baseline due to the one big beautiful bill act. Tariff revenues are substantial, but in estimates that some of us at Peterson have done, probably are unlikely to cover more than half, half of that. So that's a big hole. If we look at the data, we see that the foreign participation, the foreign willingness to buy Treasuries is much lower in relative terms than it was, say, in 2010. Then 50% of Treasuries were sold to the global market. Now it's more like a third of Treasuries. And with an investment boom going on, with low US saving, with low foreign participation, financing this is going to be expensive.

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And as you can see on the right-hand side, the average yield on treasuries has risen sharply. So it's becoming more expensive. The Treasury is currently, and has been even under the last administration, lowering duration raising the risk of rollover crises. The credit of the US was a very big topic for Alexander Hamilton, first Treasury Secretary, also one of the crafters of the checks and balances in the Constitution. And he believed that for America to be strong, the government had to have good credit. In his report relative to a provision for the support of public credit, setting out the vision that he had, he wrote, states, like individuals who observe their engagements, are respected and trusted, while the reverse is the fate of those who pursue an opposite conduct. And he was referring directly to the repayment of debts, but I think there was a broader message here, which we should take to heart today. The US has aspired to Hamilton's standard, maybe imperfectly, over its history, and it devised institutional anchors derived in part from Hamilton's writings and teachings toward that ideal. But now they're under threat as rarely before. And I believe that if we don't have a course change, the dollar supremacy will erode.

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It will become decentered in the term Adam used. Slowly and maybe then quickly, and we'll move to a multipolar system. And I will skip the last slide because I'm out of time, but thank you.

[00:26:22.04] - Moritz Schularick

Good morning, I'm Moritz Schularick. I'm the president of the Kiel Institute, and it's a great honor to be here today and talk about the evolving role of the euro. I want to thank the fantastic staff at the Peterson Institute and its president Adam Posen for your intellectual leadership. It's a true inspiration for us and what we do. I'm happy to take up the role Adam mentioned. European officials are quite hesitant to talk about this. I'm happy to give you my views on what's going on in the euro area and the role of the euro as a global currency. So I'm not reluctant, though, to use the charts of the European Central Bank. And that's one of them. And that's the state of play of the euro in a global— in the international monetary system that Maury just described. So in terms of foreign exchange reserves, of international debt, outstanding of international loan markets, deposit markets, and foreign exchange turnovers. The euro is a solid second. It accounts for roughly about 20% of across most of these markets. And as you can see, the dollar is still by quite a distant, quite a large margin, the leading currency.

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There's one dimension that's not covered here, that's global equity markets. And here, obviously, the attractiveness and the size of American markets means that the dollar really dominates global market equity shares, where 54% of global equity market capitalization is denominated in dollars. But about 10% of this is now foreign-owned, so foreigners participate quite in the US stock market boom. I'm sure we're going to come back to this later. If you look at trends over time, again, this is a chart from our friends at the ECB, the share of the euro and the US dollar in global foreign exchange reserves. It's a little hard to read, but the dollar is the yellow line here, and you see it goes down on the right-hand scale from about 70% at the turn of the millennium to now 58%. So there's been a clear decline in the share of the dollar in global foreign exchange reserves held by central banks and official institutions. You see the euro, the blue line, is very stable at a— again, now you have to look at the left-hand scale— about 20%. Not much movement. The dollar's loss, if you will, was not the euro's gain.

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What has increased increased from around 10% to now around 20%, same size roughly as the euro, are other non-traditional currencies. And among them on the right-hand side, and particularly non-traditional reserve currencies, New Zealand and other players are in there, Singapore as well. You can see the renminbi on the— this is the green, like light green line on the right-hand side. About 2% of global foreign exchange reserves is not a big player and has also not been increasing, at least not in the last 5 years. It's really been driven by the yen and other currencies that have taken up the shares from the dollar. In terms of overall global reserve composition, another winner is gold. I think that's a story that most of you have followed closely

over the past. About 20%, again, of reserves, of official reserves are held in in gold, and you scale everything down, less than half now in dollars, about 16%, 17% in euros. Right inside is the gold purchases by central banks. And I think it's over the last few years, at least, very clear that gold has been the sort of go-to place for at least for official holders of reserves, moving, diversifying out the dollar, in this idea of dollar becoming less central overall, but still by far the most important currency.

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Looking a little bit more at the short term, what do we see in terms of equity flows from the euro area to the US? Everyone has mentioned the political changes that have taken place in the last month and over the last year in the US. So far, in terms of portfolio inflows to the US, there is no significant decline, if anything, with the stock market boom. European equity investors have been keen to continue to invest in the US. In terms of the Treasury markets, Maury just looked at this. I was about to show this slide as well. I'm glad you did it. There's a long-term decline, obviously, of the foreign holdings of US Treasuries. Like, over the last 2 years, really operating at the sort of at the edge here in terms of euro area inflows into US Treasuries. Is hard to see any trend, a little dip maybe after the election, but then recovery and overall we are in the range that we've been over the past few years, including under the Biden administration. Let me turn to one area that Adam mentioned in his introduction. And I think that's, if you think about the international role of the euro and the global role of the euro remains one of the most important, if not the most important drawback and what's holding the euro back, namely, the lack and scarcity of safe assets.

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Here, we're going to have a discussion how safe US Treasury assets are. Maury told us about that. But here, in terms of world GDP, you can take other scales, but about the US supplies about 30% of world GDP in safe assets right now, owing to the high public debt, obviously, and also the housing-related, the agency debt. If you compare this to the eurozone, there's 3 lines. The black line down there is Germany. That's sort of safe asset supply, the public debt supply from Germany. Now, that's going to go up with the reform of the debt brake. So, we're counting our keel for— we're thinking that German deficits will be more in the area of 3% to 4% of GDP over the coming 5 years. So, that line is going to go up, but it's not going to go up nearly fast enough to close that gap. If you add in the other safe countries in the eurozone, Belgium, Netherlands, Ireland, etc., you get to maybe 5% of global GDP. And if you add in France, so Nicolas, we'll hear later if that's still a safe country in the safe asset sense, then we're at 10%.

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But there's a huge gap in terms of the safe asset supply between the dollar space and the euro space. And that is what I want to spend my last few minutes on, namely, So if you think about what makes a global euro, how do we approach, think about the growing role as an alternative to the dollar, which for the reasons that we've heard is becoming less central as some of the pillars on which this dollar hegemony in international financial markets was built on, some of these pillars are eroding. We're talking about reliable institutions, legal integrity. I think that is something that the European Union can certainly claim for itself. I mentioned it yesterday at the IMF, decision-making in Europe is so complicated. Once we actually reach a decision, it's really hard to get rid of it. So legal certainty is clearly there. Economic attractiveness is, I think, something that is very much debatable. Clearly, the growth dynamics have been disappointing in recent years. And although there's some attempt now, at least in Germany, to catch up on some of the investments that we haven't done in the past decade, This is still very much an open question.

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Open and deep capital markets brings us very quickly to the capital market union agenda that over the past decade has made nearly— has made very, very little progress. There is a little bit of a drive now also coming from the German side for the first time. But if anything, this will take time to achieve. But my reading here is that at least as long as I follow these things, the urgency to create a unified single European market, capital market union has never been greater than today. So I think this could be a good moment for things to move ahead. But again, we're not there. Geopolitical strength is another clear issue. Europe remains dependent on US security guarantees. It is not a sort of an adult at the table when it comes to security questions. Again, things are happening here, but we will probably have to wait at least 5 years or so for this to transform the renewed emphasis on defense in this new geopolitical environment to translate into real strength and the supply of safe assets I mentioned. There's one idea that I wanted to close on. This is something that Philip Hill, Delaine Rey, and I've been working on over the past few, weeks, namely the idea that two of these gaps in the euro's posture in international financial markets, namely the lack of supply of safe assets and the geopolitical security dimension, could be tackled jointly by creating safe assets as European joint defense debt of— we call it Team Europe— so a variable geometry of the countries, possibly even including the UK.

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Who are willing to team up on defense and use these funds to generate, to finance strategic enablers that currently are lacking in Europe for both for the defense efforts, by the way, and for civilian efforts. So AI, hyperscalers, space capabilities, the rocket shield, etc. So items with

strong dual-use character. Composition of the European team can be flexible. We would, the idea would be to issue joint European Future of Defense bonds that would minimize financing costs, they would achieve sovereign status, be included in the benchmarks and generate favorable terms. Of course, the economic idea here is to catch some of the exorbitant privilege or the convenience yield that the dollar and dollar funding markets have enjoyed over the past. If that's happening and the euro convenience yield— the Europeans managed to get this reduction in borrowing costs, this could almost be self-financing. India in the sense that the status of the safe asset in the euro would reduce borrowing costs to the— maybe not to the same extent, but similar to what has been the case in the US. I'm happy to talk about the details, but maybe I leave this. So we're thinking about if you issue 1% of GDP for each of the next 10 years, we have roughly 10% of GDP outstanding.

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That adds \$1.5 trillion or even more, \$2 trillion over the next decade. Not only to European defense capabilities and spending, but also to the depth of European financial markets. So, I think it's time to make progress in this new environment, and that's one idea. Thank you so much for your time.

[00:37:55.38] - Joseph E. Gagnon

Okay, I will be, uh, talking today. Uh, the first part of my talk is gonna be based on a paper that I put out with Tam Bayoumi, uh, who's here this morning, and it's, uh, on the Peterson website. Uh, so if you want to look it up, That's what I'm going to be going from. We focus on the US trade deficit, which has been in deficit for more than 40 years. Here is the broadest measure of the trade deficit, the current account balance, which includes all income that Americans earn from foreigners minus all income that we pay to foreigners. And so this line is a measure of the net liabilities, the net debt that we owe to the rest of the world, sort of assets minus liabilities. And it's been in deficit for over 40 years, pretty much continuously. The accumulated debt— net liabilities were reported at 90% of US GDP at the end of last year. That's an astonishing number. However, we argue that if you could adjust for some measurement issues, maybe the true net number is more like 67% GDP. But even that is a very large number. Few countries get to that point, and it's pretty much unprecedented in terms of a share of world GDP.

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I think, I think it's safe to say that in human history, no single country has ever borrowed so much as a share of the world economy. Does this risk going too far? Does it risk a crisis? And does it— does that risk threaten the dollar's global role? Well, we argue that, in fact, it's sort of

turned that question on its head. In fact, we think it's the dollar's global role that has basically driven this process. And both Maury and Moritz talked about this in more detail, but basically US financial assets are uniquely attractive to international investors. It's of course US Treasuries, but it's not just US Treasuries. It's a lot of private assets. The very large size of the US economy, the perceived safety, both military and legal, of the US system and creativity of US financial markets that are able to securitize productive assets in a— to a form that investors find attractive. The US does that more than other economies to a large extent. And that this has all enabled the dollar to retain its preeminent reserve currency role, as people discussed. I note that in particular, the work I did with Fred Bergsten a few years ago showed that there was a massive amount of what we call currency manipulation in the decade 2003 to '13.

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It persists at a much lower level to this day. And the dollar is the main currency that that goes into, which means that it tends to skew the trade deficit to the US. And as some people have noted, both Maury and Moritz, there's been some decline in the dollar's role in recent years, although it's still pretty modest and still overwhelmingly the dominant currency. So at some point, this trend of net debt to the rest of the world has got to stop. I mean, it can't go on forever. Now, it could go further. Maybe we'll get to 100% of GDP or more. I don't know. But it can't go on forever. And the longer it goes, maybe the greater the risk of a sharp reversal. We do in our paper some calculations of what it would take to just stabilize the net liability position as a share of GDP. And it turns out that the exorbitant privilege, which people talk about, we define as the fact that the US pays a lower rate of return on its borrowing than it earns on its lending. And that That, by the way, is not unique to the United States.

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It's actually shared by most advanced economies. It's the developing economies that have the reverse. They pay more than they earn. Advanced economies have exorbitant privilege, the US notably so. If we retain that privilege, then the trade part, the goods and services trade part of our deficit has to shrink by 2% of GDP. And that would require, other things equal, a real depreciation of 15% to 20%. Now, if the US has to pay the same rate of return going forward, if it loses that exorbitant privilege for some of the reasons that were discussed earlier, then that goods and services deficit has to shrink by 3.5% of GDP because we're losing the profit that can support a larger deficit. And that would require a real dollar depreciation of 25 to 30%, clearly more. But even this depreciation is not unprecedented. It's possible it would occur smoothly, but obviously the larger the needed depreciation, the greater the risk of something that would be unpleasant. So, Then jumping off from the paper, we sort of stop in 2024 data, and the tariffs are the new thing in 2025. So what do the tariffs imply for the dollar? Well, simple economic

theory— and this is with some pretty strong simplifying assumptions, but it's a good place to start— it says that 10% broad tariff should push the dollar up about 5%.

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And that would, the dollar appreciation would offset some of the effect of the tariff on the cost of imports, so it would reduce the, it would make the decline in imports smaller, and it would also make exports more expensive and reduce exports. So both exports and imports would go down equally, and there'd be no effect on the trade deficit in that basic theory. Well, starting in October of last year and going to January of this year, the dollar did appreciate in real broad terms 5%, which would be consistent with if markets thought that we were going to get an average 10% tariff. And I think that was not an unreasonable assumption at that point. However, something changed starting in late— in the end of January. Basically, the dollar has given up all those gains, and we're right back to where we started. And my view, but this is up for discussion, but my view is that the series of erratic policies, out-of-control fiscal policy, tariffs going up and down, anti-foreigner rhetoric associated with some of this, some of the stuff that the politics of grievance that Maury mentioned. It seems to me if I was a foreign investor, would I really want my money in a country that blamed people like me for its problems.

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So this is my interpretation of what's going on. And there's a risk that if you make US assets look less attractive to foreign investors, that will erode the exorbitant privilege. So what about the trade deficit? So how is that going to be affected going forward? Well, First of all, we still don't know what the size of the ultimate tariff hikes in the new regime is going to be. There continue to be new announcements about new tariffs on different products or different countries, so we don't know where that's going to be. As of September 25th, our own—PIE's own Chad Bown estimated a 21%age point increase in the average tariff, but there are issues about how you weight the tariffs and how you deal with all kinds of exclusions, exemptions, loopholes. It's devilishly complicated. It's hard to interpret even what the administration has said. The Congressional Budget Office says an 18%age point increase as of August. The Yale Budget Lab says 15%age point increase as of late September. I note interestingly that customs duties, although they're rising rapidly, have quadrupled this year. They haven't risen as much as you might have expected given these tariff announcements.

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As of August, they were only 8%age points of goods imports higher. So maybe half of what some of these estimates say. So maybe more is to come. It's not clear. Or maybe that's just a

sign of all the loopholes. We're underestimating them, or maybe there's— Evasion of some kind, we don't know. It's a bit of a puzzle. If we do take, just as an exercise, a 15 percentage point increase in tariffs, how will that affect the trade deficit going forward? Well, if the dollar stays where it currently is, which is probably the— benchmark assumption, it turns out that it's roughly the same as it has been on average for the past 3 years. So given any lagged effect of where the dollar is, that would pretty much have worked its way through. And you wouldn't expect much change in the trade deficit going forward from the dollar if it stays where it is now. It's pretty high, but it's been there for a while. Now, if you assume US grows near potential and the rest of the world maybe a bit less than potential, and this is what's consistent with the— our Peterson Outlook from last week, then you might get a little bit less export growth than import growth going forward, but not by a lot.

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So the bottom line is— and this is really— this is just really round numbers, huge uncertainty here— but basically what's left is that the tariffs are going to discourage imports, applying a standard say unit elasticity, that would shrink them about \$500 billion. And exports might shrink. That's even more uncertain. The growth differential is not a lot, but it's there. Also, there may be some hidden retaliation. There may be some US exports to actually go back into imports. And so if we don't import, we won't. So there's a lot of reasons why we might export less, but certainly that won't shrink as much as imports. So the bottom line is, I would argue going forward, if we— based on these assumptions, and this is a lot of heroic assumptions, you would expect the trade deficit to shrink. This is the goods and services trade deficit to shrink by \$300 to \$400 billion, which is about 1% of GDP. However, we saw earlier that the broadest measure of the trade deficit, the current account balance, is 4% of GDP. Not getting rid of our trade deficit, but it is a material change. Now, the effect on the broadest trade deficit, the current account deficit, may be even smaller than that, however, because there's reason to think that the investment income balance, the investment income deficit, is likely to widen.

[00:49:42.39]

For one thing, US interest rates are now higher than in other advanced economies. In earlier times, that wasn't always— not often true. And so we'll be paying more on our liabilities than we'll be earning on those assets. The other thing, though, that's interesting is that partly because— mainly because of the dollar's unique role, most— the vast majority of US bond and loan— bank loan holdings, claims on foreigners, are in dollars, about 80%. So what really drives that part of the exorbitant privilege is the spread between what we can charge foreign dollar borrowers and what we pay on our dollar liabilities. And that really is associated with the spread on US Treasuries. So here we have two spreads on Treasuries. One is a US BBB corporate

spread and one is a foreign emerging markets BBB corporate spread. And that, especially that dashed green line is kind of a big part of the exorbitant privilege. As you can see in the far right, we are now, if you squint hard enough, at the lowest level in over 25 years. I don't know how far back this data goes, but we haven't seen levels this low and there's a risk it could go lower.

[00:51:06.19]

That would reduce our exorbitant privilege. So, however, if you look at the net effect of all this going forward, so far— well, to date, it is pretty small. This is not yet really changing the US exorbitant privilege to date. But it is a risk. For the future. And, you know, there's certainly a lot of indications that investors are trying to think about this, but I would say that yet, as of yet, it's not really happened. But it is something that we— that people are beginning to worry about. I'll stop there.

[00:52:03.53] - Adam S. Posen

Thank you, Joe. Thank you, Mori. Thank you, Moritz. Rather than my posing questions or our three speakers talk amongst themselves initially, we have such a high-quality audience, I'd like to open it up for questions and comments from all of you in person. There's a microphone at the back. Jessica is holding a traveling mic at the front. If you could raise your hand. Nicolas only gets to talk if no non-Peterson person doesn't open their mouth first. He gets to talk later, just not initially. Any non-Peterson people wish to talk? OK, Nicolas.

[00:52:52.46] - Nicolas Véron

Just as a warm-up, Nicolas Véron at the Institute. One question to Maury and one to Moritz. Maury, you in April at this kind of exercise, you gave us a very similar but slightly different list of the pillars of the US dollar strength. And the last one was financial openness, where you put a question mark on whether the policies of the new administration were undermining that one. The other 6, you had 7, were being undermined, but you had the question mark on financial openness. So I'd like to have a bit of a follow-up you talked about that, but on how your assessment on this particular issue, financial openness, has changed since April. And to Moritz, I remember a conversation with a former senior central bank reserve manager in an Asian country where he said, well, we know if there's a problem with the dollar, our only port of call in the short term is the euro, but we don't like it because we remember Greece 2012. Which is your point about safe assets. And therefore, we would go to euro, but we would not want to stay there as long as the euro hasn't solved their fiscal framework.

[00:54:03.56]

Is that what you hear in terms of the way investors think? Or do you think that's an outlier in terms of that kind of real money investors? Thank you.

[00:54:13.22] - Adam S. Posen

Thank you, Nicolas.

[00:54:15.52] - Maurice Obstfeld

I don't think much concrete has happened there, but I think there are more worrying signs and more worrying institutional developments. I think the attack on Fed independence, which we usually think about in terms of monetary policy and inflation, certainly also extends to financial regulatory matters and to international financial cooperation. You know, I think to the extent that there's less coordination among global regulators through the Basel process, through the FSB, that's going to end up fragmenting financial markets. I also think we see some worrying signs in the policy sphere. For example, the first version of the One Big Beautiful Bill, the House version of that, included the so-called revenge tax. So, you know, taxing foreign profits of investors in the US. There's a great outcry. It didn't come to fruition, but it indicates the greater openness to using financial instruments to tax financial flows across the border. And I think saying, as we've seen progressive breaching of different norms and different policy assumptions, I don't think we can at all rule this out. Particularly with some of the financial stresses and the trade tensions that persist?

[00:55:55.39] - Moritz Schularick

Yeah, thank you, Nicolas. Two quick answers to your question. The first one is I don't, in my conversations, hear people worrying about Greece or fiscal sustainability to the same extent that they used to, I guess because it's now a contest of ugliness and many countries are fiscally in a Greek position, so to say, in the old Greek position. Right now, they don't look so bad, actually. Second point is, in my conversations, I sense a great openness and support for joint debt issuance. I think investors, especially bigger investors, are not attracted— they're not attracted by figuring out how much can I buy of bonds and how much can I buy of Italian bonds without moving the market. So the idea of having a large joint pool of debt that is liquid and where you can move in and out in size is something that I think markets would welcome.

[00:56:53.01] - Adam S. Posen

Thank you, Nicolas. Thank you. Oh, just a brief follow-up on that to Moritz. If you're— I mean, so our colleagues Blanchard and UBD have their euro bonds idea. You have this new idea with

Hildebrandt and Ray. Defense bonds. So with your hat on as a participant in German and Northern European debates, what's the holdup?

[00:57:28.42] - Moritz Schularick

So yeah, I should have mentioned this. I think Olivier's and Angelique's proposal to convert part of the outstanding debt into joint debt is totally complementary to what you said.

[00:57:38.26] - Adam S. Posen

Yeah, yeah, yeah, yeah. I didn't know.

[00:57:39.49] - Moritz Schularick

I think it follows the same idea. It's also a deal of support. So, I can speak, I think, for the German context. The change in the debt brake that we've had in March has relieved financing constraints. Debt issuance now is possible for defense and, at least for some time, for infrastructure projects, a few hundred billion. That was for domestic politics, that was a big struggle. And the appetite to go the next step in terms of European joint issues integration is, I think, right now, unfortunately, still limited. Merz has taken quite some criticism for changing the debt brake because he promised he wouldn't, and this was always seen as a sign of German fiscal rectitude. So now doing the next step, I wish the German political system becomes more open, but it's still a long way, I think, to get there. And we constantly need to remind them that this is in your economic self-interest, this lowers borrowing costs, this makes Europe stronger. This is not about the southern states somehow exploiting German fiscal—

[00:58:53.31] - Adam S. Posen

It's not about the debt of grievance, to invoke Maury. Maury, sorry, what were you going to say?

[00:58:59.28] - Maurice Obstfeld

Well, I don't want to be too obsessed with Hamilton, but just that what he did is interesting in this context because his scheme was that the federal government would assume the debts of the various states, and it was a way of actually justifying a federal taxation power to service those. Europe kind of has the adverse problem that if you issue all this joint debt, where is the taxation power that that covers it. And I think there's some reluctance on this score because the institutional framework for paying the debt is not clear.

[00:59:35.56] - Adam S. Posen

I'll just mention that Jacob Kirkegaard and I did a report with some colleagues contributing for the European Commission several years ago in which we talked about the idea that national defense would be the way into joint issuance. Again, this— the logic is there. Please.

[00:59:56.54] - Audience

Yes, Jim Melonis. I just had a question on the macro fundamentals in the US, the savings investment balance. If we look at the government sector, clearly there's a push to dissaving. The corporate sector is going to increase investment, certainly on the AI basis. The household sector in the US has a relatively clean balance sheet. So don't the factors seem to be driving towards wider current account deficits, especially if US growth turns out to be relatively good? And then on Europe, how does the ECB and the European institutions deal with a core country facing a fiscal and economic crisis, i.e., France? Does the euro then move towards more integration? Does it need another crisis to get integration, or could that be, you know, the final straw that breaks the camel's back?

[01:00:41.53] - Adam S. Posen

Thank you, Jim. Before Joe responds to the first question, let me get one more question from the audience because we're getting near time and I want to make sure all the questions are Please.

[01:00:52.40] - Jacob Funk Kirkegaard

Yep. Jacob Kirkegaard from the Peterson Institute. Just a quick question. One thing you didn't mention, except when there was a talk about the rising role of gold as a reserve currency, was the use of currencies, particularly the dollar, for economic sanctions. Should that by extension mean that this issue is really not relevant in your mind for the use of it other than a flight to gold? And if so, what are the implications for such a view on the ECB's reluctance to, for instance, accept confiscation of Russian assets held in Euro financial institutions?

[01:01:30.14]

Thank you. Thank you.

[01:01:31.07] - Adam S. Posen

Well, somebody else popped up, so Yide, quick. I have a question for— Could you identify yourself?

[01:01:39.34] - Audience

Yeah, my name is Yide Zhao from Shanghai Development Research Foundation. I have a question for Maurice. In your presentation, you did mention the stablecoin. I'm wondering whether you can illustrate it more about the impact of stablecoin on the position of US dollar, which will strengthen the US dollar as someone claim, or you think it will hold US dollar position in the future?

[01:02:15.39] - Adam S. Posen

Thanks very much, Ide. So Joe, why don't you start on the issue that Jim raised with sustainability in the US?

[01:02:24.43] - Joseph E. Gagnon

Yeah, I think that it's easy to point to factors that you expect would increase the US trade deficit. As you say, the fiscal deficit is very large and possibly getting larger. All the AI boom, although other sectors of the economy not booming so much, so that pulls that back. Households perhaps beginning to retrench a bit. So it's not clear. I would note all the money that the administration wants foreign countries to commit to investing in the US would seem to argue for a bigger trade deficit because the trade deficit is the inverse of the investment coming in. I would only point out that if all this were expected to be pushing up the trade deficit, the dollar should be stronger. So markets are not seeing it. And unless the dollar goes up, I don't think the trade deficit can widen.

[01:03:15.30] - Adam S. Posen

Is it the markets are not seeing it, Joe, or is it the markets are viewing that as outweighed by some of the other issues you raised? I mean, is there a way you and Tam could do an exercise and discern those two hypotheses one from the other?

[01:03:29.55] - Joseph E. Gagnon

I'd have to think. I mean, yeah, if you looked at the sectors and— yeah, we haven't done that analysis. Maybe it's worth doing.

[01:03:38.02] - Moritz Schularick

I don't know. Lawrence. So let me take this question on the ECB and the crisis in one of the core countries. I think, first of all, we're not there. The ECB has the instruments to ensure what they call proper market functioning. And the presence and the existence of those probably play

their role already. But I think deeper down, your question is one to, like, if push comes to shove, what happens in terms of fiscal integration and monetary integration. It's important to remember there's a deep paradox in European fiscal affairs between Germany and France. So Germany is basically fiscally hawkish, but if you will, nation-state dovish. Germany would go the next step towards more political union. That's the DNA after '45, the European integration. Germany would have a much easier time giving up the nation-state in the sense that Maury also mentioned in terms of taxation capacity, et cetera. France is fiscally dovish and nation-state hawkish. So France is ultimately not willing to sign that marriage contract or hasn't been. There's a very strong, long tradition of keeping national sovereignty and there's a little bit of a have your cake and eat it attitude to Europe always in the room.

[01:04:52.10]

If that crisis in France leads to the point where France really needs that fiscal support from Europe, I could see, and that's a hope obviously also along these defense lines possibly, that there is a push towards more integration that could really make a big step forward— I mean, a big step forward for Europe.

[01:05:11.47] - Adam S. Posen

Thank you. Maury, do you want to do stablecoins or anything else?

[01:05:14.01] - Maurice Obstfeld

Yeah, I'll take the stablecoin question. I think it's not clear how the whole stablecoin enterprise affects the strength of the dollar. And there are about \$1 trillion in dollar bills out there that are abroad. These migrate into the stablecoin system because it's a much more efficient way of doing transactions that are undetected. You know, not clear how that pans out. And I think in terms of the point that Jacob mentioned, I think US-based stablecoin companies would be a very tempting mechanism for sanctions on other countries. I think there's a lot of concern in the rest of the world about financial stability, about dollarization, about just the AML/CFT implications of all the stablecoin use. I think there would be pushback on that. I just want to say one thing, if I could, about the saving-investment imbalance. How do you reconcile a big excess of investment over saving with a depreciated dollar? Well, it's by inflation. Basically, the economy may temporarily have a trade balance surplus, but you have excess demand, and this pushes up prices. And then the real exchange rate doesn't depreciate as much as the nominal, and you go back to where you were.

[01:06:46.33]

So I think that's the answer to the conundrum. It's not really a conundrum. It's a question of timing.

[01:06:52.00] - Adam S. Posen

Well done. This is why we read Maurice's textbook. It's relevant. With that, let me thank our three speakers, Joseph Gagnon, Moritz Schelernek, and Maurice Obstfeld for taking up an update on the changing dollar regime. Let me just remind all of you in the global audience online as well as here today At 1:30 PM today, we— DC time, I'll be having a conversation with Tiff Macklem, the Governor of the Bank of Canada, very seasoned monetary civil servant and wise person, but also fascinating to think about the country that is most integrated with the US and has to navigate through these issues. And a reminder again to pick up on Europe tomorrow at 1:00 PM DC time, we'll be having Benazir Quraish, Knut Krogstrup, Rayn, and Ubideh talking about Europe in the changing international monetary system. Thank you all very much.