EconoFact Chats: The United States' Role in a Changing International Economy
Oleg Itskhoki, Harvard University
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I'm Michael Klein, Executive Editor of EconoFact, a non-partisan, web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
In the wake of the 1991 Gulf War, then President George H.W. Bush heralded the beginning of a post–Cold War era, the New World Order. A central part of that idea was that there was, in his words, no substitute for American leadership. Today, the situation is very different. The America First view of many people, including those in the administration, wants to see a withdrawal of the United States from the world stage. There is also greater confrontation rather than cooperation, especially in the realm of economic issues, as shown by the imposition of tariffs on the so-called Liberation Day on April 2 of this year, and the subsequent volatility of tariff policy. What does this mean for the current state of the world economy, and what does it mean for the future? To address these questions, I'm very pleased to welcome to EconoFact Chats Professor Oleg Itskhoki of Harvard University. Oleg is a leading scholar in the fields of international monetary economics and international trade. He was awarded the prestigious John Bates Clark Award by the American Economic Association in 2022—an award given every other year to the economist under the age of 40 working in the United States who has made the most significant contributions to economics. Oleg won this award for his fundamental contributions to both international finance and international trade. Oleg, thanks for joining me on EconoFact Chats.

Oleg Itskhoki
Hi, Michael. Great to be here.

Michael Klein
Well, it's wonderful to have you. The United States was at the center of the post–World War II international monetary system. The General Agreement on Tariffs and Trade, the GATT, worked to lower tariffs across the world in that post–World War II period, and the hand of the United States could be seen in the emergence of this rules-based system after the non-cooperation and the economic disasters of the interwar period. How did we get to this post–World War II, low-tariff situation, and was the United States' role instrumental, and even essential for this happening?

Oleg Itskhoki
Yeah, this is a super interesting question, because we understand much better the forces that lead to high-tariff equilibrium, or low-cooperation equilibrium, because each country, arguably, myopically finds it in its own interest to have trade taxes, to try to exercise the monopoly power that it might have in the world markets. And so it's much easier to understand equilibrium. This is the Nash equilibrium, really, in the global economy where there are tariffs, everybody imposes

tariffs on each other, right? And so what was unusual and very special about the post–World War period is that we entered the period of globalization, when the tariffs were falling, greater cooperation between countries, increased global value chains, and this was all happening arguably because of the leading role of the United States, right? And so the U.S. was the biggest player, and it found in its interest to design these rules that promoted cooperation, and perhaps not just because of the economic interest, right? There were a lot of political interests involved, geopolitical interests involved. So the Cold War was a very important thing, and the U.S. sought alliances with other developed democratic countries to be more successful in the Cold War, and that promoted cooperation. And arguably, the U.S. was the cornerstone that held that whole system together. Other countries enjoyed the benefits of joining that system, and the benefits of participating in the world of low tariffs, as long as the U.S. was interested in sustaining it. But the big question was, what made the U.S. really want to do that for such a long period of time?

Michael Klein
Well, trade offered this country and much of the world many benefits, but of course, there were also a lot of dislocations. For example, manufacturing employment in the so-called industrial countries like the United States declined. Some of this was due to automation, and some was likely due to trade. But, you know, of course trade got the lion's share of the blame. By 2016 both political parties in this country took a more protectionist stance. The Trans-Pacific Partnership, what's called the TPP, was meant to bolster trade among countries in the Pacific Rim and limit China's economic ascendancy, but that was canceled by President Trump when he first took office. But at that time, the Democrats were sort of turning against it as well. Why do you think, Oleg, there was this shift by both Democrats against the Obama administration's push for TPP, and Republicans, who had traditionally been a party in favor of free trade?

Oleg Itskhoki
So indeed, 2016 was probably a turning point, because both parties were against the TPP, and TPP was arguably the next phase in globalization, where globalization would be not for all, but for like clubs of countries. And in particular, this was sort of like a multilateral trade agreement which excluded China specifically, right? So if you think, in that period, there is a shift from having broad trade agreements which included pretty much every country, to more regional trade agreements. TPP was supposed to be this flagman trade agreement between the U.S. and other countries of the Pacific basin, which would have promoted trade but excluded China in view of this geopolitical competition. And it would have seemed that this is exactly the right policies once both parties acknowledge the increased geopolitical tensions and competition with China. At the same time, something happened, and in 2016 both political parties actually did not want to support the TPP, right? It was viewed as an Obama-time legacy, and neither candidate Clinton nor candidate Trump actually wanted to stand by that agreement, and it would have, in all likelihood, not have been signed under either of the administrations. It may well be that this is a fluke—that we still see that Americans actually do like trade, and the typical American voter prefers trade to no trade. So it might have been a fluke of the 2016 election, but nonetheless, it really marks a turning point in U.S. policies. Whether or not the voters will want to reverse those policies again, and go back to the world of greater globalization, lower trade tariffs, is an open question for now, but this did lead us to where we are.

Michael Klein
Your research, for which you've been justly recognized, points to the importance of thinking about the joint outcomes of international trade in goods and services, along with international trade in assets—that is, international macroeconomics. Can you briefly explain why these two sets of trade are necessarily interrelated.

Oleg Itskhoki
Right. Well, I would argue that they're not necessarily interrelated. They happen to be. And in particular, so for the United States. When we talk about trade, we really talk about gross trade, right? Total trade volumes, both exports and imports. And you can imagine a situation where countries run balanced trade, but they trade a lot, right? So both exports and imports are large, but trade is balanced, and so there are no net trade imbalances. And so what it means, from the macroeconomic perspective, is that each country basically equalizes savings and investment. When countries run trade imbalances, it's the opposite situation, for example when the U.S. runs a trade deficit, this is the situation when U.S. savings are smaller than U.S. investments – in other words, American consumers can enjoy higher levels of consumption for given levels of investment. Why? Because the rest of the world is willing to invest in the U.S. economy. And the other side of this is the trade deficit that the U.S. observes.

Michael Klein
I would just note for our listeners, this is not a theory. This is just a necessary thing. It's an accounting identity, right Oleg?

Oleg Itskhoki
That's correct. So trade deficits translate into current account deficits, which is exactly the gap between savings and investments of a country, right? And so whenever a country is trying to reduce a trade deficit, it needs to do one of two things. It either needs to reduce consumption and increase savings, or reduce investment. And arguably, neither is in the interest of a country, but it might be a long-term necessity for adjustment, right? And that's why we call these global imbalances.

Michael Klein
So when a country like the United States has been running a trade deficit for a long period of time, that means that we have to sort of sell IOUs to the rest of the world. It's as if I was always spending more money than I was earning. So I would have to, like, sell IOUs, you know, sort of take out loans and things like that. What is the effect of that on a country's overall performance and macroeconomy?

Oleg Itskhoki
Right. So in principle, if this situation can be sustained for a long period of time, it means that the country can enjoy, as we just discussed, both higher consumption and higher investment. Situations like this can arise when a country is a particularly interesting place for investment for other countries. So other countries generate incomes that they want to allocate to investment in different parts of the world. And if the U.S. is a particularly appealing place for investment, this situation can arise. And this is arguably what we've been seeing over the last number of decades, right? That a lot of countries, including China, including oil-exporting countries, have generated

large incomes that they wanted to allocate in the form of investment in the United States. This obviously improves the production capacity of the U.S.—the fact that investment comes here—but it also allows the consumers in the U.S. to enjoy higher levels of consumption, and this is reflected in the trade deficits. So the danger of this situation is, of course, the adjustment that may need to happen, and sometimes sooner than later. So if these capital flows revert for whatever reasons, it means that there would be a necessary adjustment, either in the form of lower investment, or in the form of lower consumption in the United States. What's remarkable about this situation is that the U.S. sort of enjoyed these trade deficits for about four decades now, right? And the big open question: could the situation have persisted for another couple of decades? Or is it meant to be diverted at, you know, at some soon date in the future.

Michael Klein
So that brings me to the issue of tariffs and the change in policy that President Trump has enacted, I guess most notably with the April 2 Liberation Day announcements. First off, many people thought that in advance of the tariffs that President Trump promised to impose, that tariffs would cause the dollar to strengthen. The basic idea there is that tariffs reduce the demand for foreign goods, and therefore the demand for foreign currency needed to purchase those goods. So the reduced demand for foreign goods means the price of foreign currency would go down. That is, the dollar would strengthen. Well, this is a theoretical result. There was also evidence that in prior cases this happened, right.

Oleg Itskhoki
Correct. And so it's a strong theoretical result. It's essentially impossible to write down a model where the direct effect of a tariff would be to cause a depreciation of the currency, and the logic is very clear why this is such a robust result: tariffs tend to reduce both sides of trade. Tariffs reduce both imports and exports. It's not an instrument that actually is good for rebalancing trade. It's an instrument that directly affects the quantity of trade, and the logic behind it is the country budget constraint, right? It cannot be that the country just imports less. In the long-term sense, if you import less, you also export less. And what's behind that mechanism is the adjustment in the exchange rate. So indeed, when there is a tariff, the exchange rate appreciates to partly undo the effect of the tariff on imports and also making exports smaller. And so this is true essentially across all models that we write, but it's also true kind of in the data most of the time. How can it be that the dollar moves in the opposite direction in April? Well, you have to really appeal that some other shocks have happened. It was not just the direct effect of tariffs. Some other things have happened in either the goods or the financial market that caused the dollar to depreciate with the tariff.

Michael Klein
And in fact, the dollar has weakened throughout the year. I guess there's a little bit of a puzzle here. I'll refer to something that I did with Charles Collyns for EconoFact. We looked at the effect of uncertainty on the dollar, and we looked at sort of these four-month periods, and what we found was that, in general, when there was greater policy uncertainty, the dollar actually strengthened. The dollar had this sort of safe-haven property—that people would flock to Treasury bills and the dollar at that time, even when the crisis started in the United States, like 2008. But we found two periods when this didn't work, when it worked the other way, when there was greater policy uncertainty and the dollar weakened – and the two periods were the

beginning of Trump's first term, and the beginning of Trump's second term this year. So does that strike you as sort of an explanation of what's going on? That there's this greater uncertainty? And, you know, you're alluding to the fact that people wanted to invest in the United States for a long period of time. Do you see this shifting now?

Oleg Itskhoki
I would argue uncertainty is one of the things that's happening. But arguably, there are more effects happening at the same time. And you're exactly right: most of the time, the dollar was viewed as the best hedge out there. So when there are bad news about the world, about the world economy, even if they originate in the United States, like the housing crisis in 2007, 2008, and 2009—this was the bad news coming out of the U.S. that triggered a global recession, but the dollar appreciated nonetheless, and the investor viewed the dollar to be a good hedge—that in bad times, it actually increases in value. And so what happens now is that, again, bad news for the world economy came out of the U.S. with the trade war, but now it's actually viewed like perhaps news about further deterioration of the quality of the U.S. assets, or U.S. institutions. We can think about the likelihood of sustained payoffs on the U.S. assets. Or we can think about the credibility of U.S. monetary policy going forward. And to the extent the trade war might shake the beliefs of the international investors about the persistence of good policies in the U.S., and good payouts on U.S. assets, they would think of the U.S. dollar as less of a good hedge. And that's exactly what happens in April. Bad news are associated with a sharp depreciation of the dollar, despite interest rates on the long-term U.S. debt going up. Typically in all previous periods, higher interest rates on U.S. debt tended to appreciate the dollar. But now suddenly there is this massive movement in the opposite direction, which is much more typical of developing countries than rich countries, right? And so this shakes the belief of investors into the properties of the dollar. It stops looking like the best hedge out there. And it's very important that what investors used to do—they used to buy American assets without worrying too much about the value of the dollar – so you hold dollar debt for the return that you can get on it, but you don't worry as much about the exchange rate, right? Because in bad times, the exchange rate tends to appreciate. And so now the investors have to take into account, when they hold American assets, they have to worry about the exchange rate, and as a result, they want to buy insurance against exchange-rate depreciation.

Michael Klein
Another striking thing is that we didn't see a similar outcome in the stock market. The U.S. stock market continues to rise. So what do you think is going on with that?

Oleg Itskhoki
Yeah, no, this is remarkably interesting. I would add here, not just the stock market, but also the yields on U.S. government debt. At first these yields went up, so the price of U.S. debt fell, but then both the equity market and the debt market recovered, while the dollar did not recover, right? So the most remarkable thing about this period is we've seen mean reversion in most asset markets, but not in the exchange rate, and the dollar remains depreciated by about 10% since the beginning of the year, with no signs of mean reversion, unlike in other asset classes. And so the theory here—and we have some empirical data to support this—is that it's very difficult to sort of diversify away from the U.S. The U.S. is the main source of assets for world savers, and that's been like this for decades now, and so it's very difficult to substitute American assets, because

when you sell them, you need to buy something else. And there is just not that much out there that you can buy with comparable safety and return properties. But what did happen—and we see it in the data—is that the same investors that used to hold U.S. debt, both government debt and corporate debt, used to hold it without hedging it very much in the currency market. Now, whenever they hold U.S. debt, they want to sell the currency risk. Selling the currency risk essentially means selling dollars forward on the forward and futures market. And when that happens, somebody needs to absorb that risk. And so the way the markets adjust to that is by depreciation of the dollar. The dollar needs to depreciate sufficiently for the other players in the market to be willing to accept the risk of potential future dollar depreciation. That's exactly the shift that's been happening since the beginning of 2025.

Michael Klein
And discussing this role of the dollar, we should also mention another role of the dollar: that the dollar is used for international transactions, even if the United States is not one of the parties to the transaction. So, for example, trade of goods between Japanese companies and Brazilian companies is denominated in dollars, as is trade in assets between, say, investors in France and England. Do you think this role of the dollar as what economists call a vehicle currency, could be imperiled by current American policies?

Oleg Itskhoki
Yeah, Michael, I want to add to this another role which is very related, is the role as an anchor in monetary policy. So it's not only that exporters in different countries in the world choose dollars as a vehicle currency to price their exports in. Also the central banks in many, many, or even majority, countries in the world are not fully floating their exchange rates. They partially peg it, and when they peg it, they tend to peg it to the dollar. And so these two joint roles contribute to the global dominance of the dollar in various markets—in the goods market and the financial market, in settling transactions, and so on. And so indeed, this is correct, that as we see erosion in the role of the dollar in the world market, this erosion probably will happen across the board. It will happen for assets in which investors save, it will happen for reserve currencies in which central banks hold their reserves, it will probably diminish the role of the dollar as the anchor currency for monetary policy and as vehicle currency for international trade transactions. So right now, we arguably are seeing the first change when investors are sort of challenging their beliefs about the dollar being the best hedge out there. Those other roles might follow. It's an open question whether the current trade war was the trigger of that shift and that shift will happen quickly over the next couple of years? Or maybe we're just observing sort of the first step along many, many steps that will take, perhaps decades, before we fully see it. But definitely what happened in 2025 is a very important event for the role of the dollar in the world market.

Michael Klein
Yeah, I think another contributing factor to the central banks is President Trump was musing about taxing central banks for holding Treasury bonds, and one of the consequences of that is that the price of gold has skyrocketed. It's well over $4,000 an ounce now, up more than 30% since the beginning of the year. Oleg, so what would the consequences of a shift away from the dollar in all these roles be for the United States, maybe for the world economy, right?

Oleg Itskhoki
Right. And so you pointed out gold. We can also point out Bitcoin, that it's also at record-high prices, although fluctuating all the time. And so, clearly, the investors around the world are looking for alternative assets to save in. They probably realize that they've been overexposed to the U.S. asset markets, especially given the uncertainty about financial policy of the U.S.—you know which taxes or tariffs are going to be imposed next, are there going to be some financial freezes or something like that. This all probably should keep long-term investors around the world concerned about being so overexposed to American assets, and so they're seeking alternative stores of value. And this is exactly the reason why the gold prices are skyrocketing. So now the issue for the investors is that there are not that many asset classes that they find appealing, right? And so you don't have to provide the best test—well, you don't have to provide the asset that's perfect. You have to provide the asset that's just better than alternatives. And the U.S. still keeps that role. It's very hard to find substitutes. There are a couple of possibilities here. So one possibility is that we'll see an emergence of another safe asset somewhere in the world, and so Europe could play that role. Countries that have fiscal capacity in Europe—and these are the Northern European countries, Germany, some Central European countries that still have fiscal capacity, they can expand sovereign debt, and that could become an alternative safe asset. What we will see then is potentially investors will start leaving the dollar assets and shift into, say, European assets, or maybe a safe asset will emerge somewhere else in the rest of the world. Alternatively, investors would just want to go to just totally, altogether different asset classes, not sovereign debt, but some alternative assets that might have emerged somewhere else in the financial system. In all of these cases, we'll likely see higher yields, or higher yields for longer, on U.S. debt. What does that mean? This means that the cost of borrowing for the U.S. government will be higher, and we're observing it right now, right? So half of the fiscal deficit in the U.S. are the interest-rate payments. And this is completely a different world compared to five years ago, when the interest rates were close to zero, when debt was essentially free to service. And now we're in a world where the U.S. has to pay 3–4% on its debt, which contributes half to the total fiscal deficit. And so what's important—this is a higher cost for servicing the deficit for the U.S., magnifying the fiscal problem, perhaps, and arguably the main problem that the U.S. government faces right now. But also it trickles down to the cost of borrowing for private borrowers in the U.S., whether these are firms that need to borrow for capital investment, or households that need to borrow for mortgages and stuff like that. So these higher interest rates on U.S. debt in general are increasing the costs of financing for the U.S. economy as a whole. And these are arguably the main financial consequences of the trade war right now.

Michael Klein
And the greater cost of servicing the debt means that there's less money for things like infrastructure or defense or the social safety net. So we're going to see that effect as well. A through-point in this whole discussion, Oleg, has been the central role of the United States as an economic hegemon, a country whose assets and currency are at the center of the world economy and whose leadership was important for generating a rules-based trade system. Do we need a hegemon for the world economy? Could another country or another set of countries play this role? And if we don't have a hegemon, what's likely to happen? At the beginning, you talked about a sort of Nash equilibrium—you know, people might know that as the prisoner's dilemma—that without cooperation, you have these worse outcomes emerging. Is that what could happen without a hegemon?

Oleg Itskhoki
Yeah, and this exactly returns us to the beginning of the discussion. How did we enjoy 50 or 60 after-war years of increasing cooperation between the countries in the world? And arguably the U.S., as a large country among the rich, developed, democratic countries of the West, was playing a crucial role. It was really the center of attraction and the country that set the stage for the rules-based order. And so what we're seeing right now is, when you take the U.S. out of this equation, it would be very difficult to sustain a rules-based order. So the big question—whether this was inevitable or it's an unforced error, a blunder of the U.S. government. And so you can probably make the case both ways, that this is a myopic, non-strategic blunder—in search of short-term gains in the form of tariff revenues and the like, sacrificing the rules-based world order that the U.S. benefited from dramatically, but other countries benefited from it as well. This is one view. The other view could be that, well, we do really have two superpowers right now, and if you view the world through the prism of geopolitical competition between the U.S. and China, an argument could have been it was just unsustainable for U.S. to play the role of sort of providing this public good of rules-based institutions and rules-based world order when China was taking advantage of this. I'm not sure I fully endorse that view. In a way, China was following some of the rules, and not following the other rules, and the rules could have been designed better to provide incentives for China to, like, sort of follow the things that are expected. But, you know, there is this argument to be made that with two hegemons, it's very difficult to sustain the equilibrium we've been enjoying. The previous Cold War, where the Soviet Union was largely excluded from the institution, showed that, in principle, you can build a rules-based world order excluding one country or one region from this. And so the big question right now, are we going to observe much less of a rules-based—or are we going to observe two regions, like a fragmentation of the world, and two regions, a bit similar to how it happened during the First World War? And we're going to have a kind of second period of the Cold War now with China, and we'll just observe two fragmented regions of the world. So these are these big, open questions, and we're going to see how it plays out in the coming probably decades.

Michael Klein
Well, this has been an incredibly interesting time for people working in the field of international economics, but unfortunately, it's a little like being an epidemiologist during a plague. But in both of these cases, it's important to have insights from either economists or medical experts, and so I want to thank you for sharing your insights with our listeners and with me today, and I appreciate you coming on the podcast.

Oleg Itskhoki
Absolutely—it was a pleasure.

Michael Klein
This has been EconoFact Chats. To learn more about EconoFact and to see the work on our site, you can log on to www.econofact.org. EconoFact is a publication of The Fletcher School at Tufts University. Thanks for listening.