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MACROCOSM

Predictions for 2025: Tariffs

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Based on 2018-2019, there will be tariffs and they won't matter. Does the Fed understand?

Yesterday we published our brief and high-level 2025 outlook for the economy and the markets (see "Predictions for 2025: Macro and Markets" January 2, 2025), following on our 2024 review (see "Our Predictions in This Most Unpredictable Year" December 27, 2024).

Today, we start diving into the details what will be the drivers. *The most fascinating policy domain of 2025 will be Donald J. Trump's approach – and that of his team – to trade, tariffs and the US dollar.*

- *Trump's own position seems simple enough*, and it is well known from his first term.
- *He believes America is being immiserated by persistent trade deficits with most counterparty countries* – we buy lots from them, but they don't buy as much from us.
- *This can be solved, he believes, by tariffs*, which raise the effective cost of foreign imports to Americans, and incentivize them to buy domestic alternatives (alternately, fear of US tariffs incentivizes counterparty countries to buy more American goods, or reform their own trade barriers, to prevent tariffs from being implemented).
- *Trump believes tariffs will produce tax revenues that can be used to pay down the US debt or lower other taxes Americans pay*.
- Trump also believes that the "tax incidence" of tariffs is such that counterparty countries effectively pay them, not US buyers.

Trump has chosen for his team people with deeply held and more complex belief-systems around these issues. Vice President-elect JD Vance would seem to believe that trade deficits arise necessarily from the status of the US dollar as the world's reserve currency, and have led inexorably to the generational loss of manufacturing jobs in America. Trump's Chair-designate for the White House Council of Economic Advisors, Stephen Miran, believes the same thing in a highly elaborated way, set out in a position paper last month that is very well worth reading. We have some sympathy for these ideas, and explored them last year with Michael Pettis, who has for over a decade been the thought-leader in regarding reserve currency status not as an "exorbitant privilege," but an "exorbitant burden" (see "Video: TrendMacro conversation with Michael Pettis on the risk to the US dollar losing reserve currency status" August 27, 2024).

Update to strategic view

US MACRO, FEDERAL RESERVE, US STOCKS, US BONDS, FX: Trump has surrounded himself with advisors like Miran and Vance who want to reform the global trade "system" by weakening the dollar and potentially giving up reserve currency status. It is not obvious that such status is conferring any benefits. But Trump supports a strong dollar and reserve currency status, as USD strength since the election confirms. He wants to use tariffs as both threats to change counterparty behavior and disincentivize imports. Tariffs are just taxes, and changes in them have to be evaluated in context with overall changes to the tax code – including reducing other taxes. The 2018-19 tariff experience shows little discernible effect from tariffs on the trade deficit, growth, the dollar or inflation. The year-end correction in stocks and back-up in yields is driven by a narrative that the Fed believes, despite history, that tariffs are inflationary – and is already adjusting policy tighter in anticipation. Based on 2018-19, tariffs will come, and they won't matter. The Fed's inappropriate reaction is the bigger risk.

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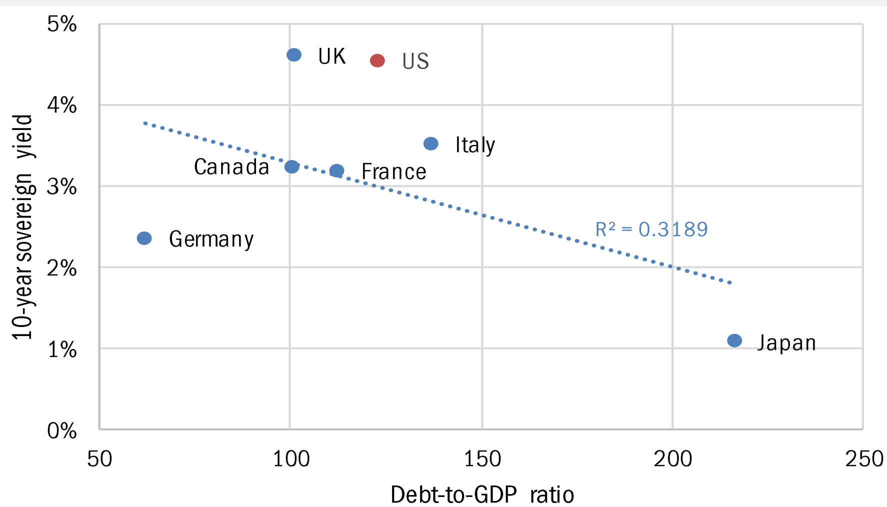
- In their systems of thought, the key idea is that *__reserve currency status keeps the US dollar artificially overvalued__* – because it is, uniquely, in demand as an official global store of value and not just a local transaction medium.
- Counterparty countries, in order to accumulate dollar reserves, must of necessity run trade surpluses with America as we buy their goods made all the more attractive to us with our overvalued dollars. The dollars they receive for their *exports to us* are not returned to us in the form of buying *imports from us*, but rather as investments in US instruments such as Treasury bonds. *__The overvalued dollar and lack of foreign demand for our goods leads to a grand bargain: they get manufacturing jobs with us as customers, and we get to borrow more than we would otherwise at lower interest rates subsidized by their savings__*.
- Miran and others call this a "system" in which the US is obligated, as though by treaty, to produce deficits to make possible dollar accumulation by counterparty countries. They believe the "system" is "out of balance" and cannot achieve "equilibrium." The problem is we don't know how they, and they alone, are privileged to know what "equilibrium" is. Surely it's not so simple as a world in which no nation has a non-zero trade balance with any other – that's basically a world of barter – and yet it almost seems that's what they have in mind. *__We see global trade not as a "system" at all, but as a spontaneous self-organizing order that is, by definition, perfectly in equilibrium__* – it just may not be the equilibrium that a particular economist (Miran) or politician (Vance) would prefer.
- So setting aside their choice of terms, let's just say they don't like the way things are and want to change them – fair enough – but how to do so? And do we dare?
- Miran and others point out that the bargain has unraveled, anyway. *__US sovereign borrowing costs would not seem to actually reflect any benefit__*. Compared to other G-7 nations, the US is tied with the UK for the highest nominal borrowing costs (it's worse in real

● G-7 (ex-US) sovereign borrowing costs versus debt-to-GDP ratio ● US



Source: Bloomberg, TrendMacro calculations

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terms). Controlling for debt-to-GDP ratio, our costs should be considerably lower just to be on trend with the other six nations (please see the chart on the previous page).

- You can tell yourself it would be even worse without reserve currency status, but other than that it's hard to see the "exorbitant privilege" we supposedly have. So why not dare to reform the "system"?
- For thinkers like Miran the shortest path would be to weaken the US dollar. That would make it less attractive to hold, and more attractive to exchange for US goods and services. So we should give up the status of the US dollar as a reserve currency so there will be less demand for it – but how? It would require an incentive system designed to make the USD costlier to hold, *likely a tax on official foreign holdings of US Treasury securities.*.
- But such holdings plateaued a decade ago, and have been falling for the last three years. And it's amusing to recall the time, not so long ago, when such theoreticians thought taxing Americans who bought foreign securities – the very opposite policy! – was the way to reform the "system," hence John F. Kennedy's Interest Equalization Tax.
- But the real problem with that approach is that Trump doesn't want to do it. *He has said repeatedly he sees a strong dollar, and the dollar's reserve currency status, as an emblem of a strong America*. Indeed he has threated massive tariffs on nations that turn away from the dollar as a reserve currency.
- *The strengthening of the trade-weighted dollar by more than 5% since Trump's election implies the market believes him*.
- Trump does not seem worried, as Miran is, about accumulation of US securities in foreign hands. Indeed, Trump welcomes foreign investment in the US – hence his offer to provide special regulatory forbearance for investments over $1 billon, which has already snagged an offer from Softbank for 100 times that.

For all the intellectual elaborations of Miran, and even Vance, it seems to us that, for Trump, tariffs – not capital controls – are the go-to policy lever. *He wants to use tariffs to make Americans buy fewer imports, and/or as a threat to make other nations buy more of our exports. It's that simple*.

- First and foremost, *he sees tariffs as an all-purpose threat* that can be brandished to coerce other nations to cooperate with his objectives, whatever they may be. He does not recognize other nations' *right* to access the American market – it is a *privilege*, and one that he can withhold with tariffs, or encourage with regulatory relief. Among his very first acts as president-elect, he threatened both Mexico and Canda with 25% tariffs if they did not control the flow of illegal immigrants and of fentanyl across their borders into the US.
- Tariffs are an economic weapon, but in this case the objective sought by using them as a threat isn't itself economic. Already, the leaders of both Canada and Mexico seem to have conceded to Trump. And the stock market didn't waver for even one day when the story broke – how unlike its shocked reaction in May 2019

when Trump threatened a mere 5% tariff on Mexico for the same purpose. Markets appear to understand Trump's tariff game now (we explained it all then – see "On the Mexico Tariffs" May 31, 2019).

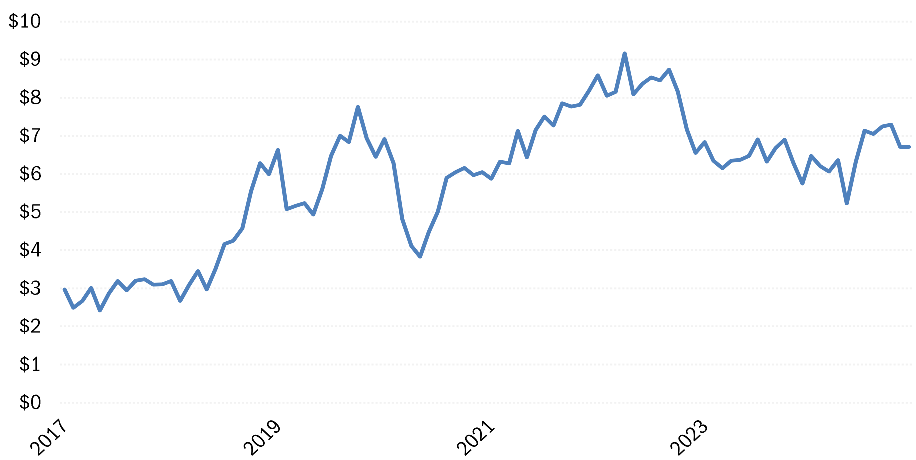
But Trump has *economic* objectives for tariffs, too. So let's talk about *those* tariffs…

- First, reframe your brain (see "TrendMacro conversation with Scott Adams" September 6, 2023) about tariffs: *tariffs are simply taxes*.
- *When we hear Trump say he wants to impose tariffs, we hear him say he wants to impose taxes*. So in anticipating how tariffs might affect the economy and the markets next year, we start by thinking about how higher taxes might affect the economy and the markets next year.
- But here too, even strictly in the economic domain – and understood as taxes – tariffs can still be merely a threat. *Trump's threatening to impose them could be used to extract agreements from other* governments to buy more US goods or lower their own trade barriers so that their citizens will be motivated to do so.
- The tariffs on China from 2017 to 2019 likely began in that spirit. Indeed a deal was reached, but with the onset of the pandemic all deals were off – this one was never rekindled, and the tariffs were never removed by Trump or by Joseph R. Biden (though Biden promised to do so in the 2020 campaign).
- But let's set the idea of threats aside and just think of tariffs as taxes. It's worth remembering that *taxes will be very much in the spotlight in 2025 with the impending expiration of individual income and estate tax provisions of the 2017 Tax Cuts and Jobs Act*. There will be a great deal of horse-trading as expiration looms at year-end, and tariffs will be in the mix. Trump has repeatedly advertised tariffs as a revenue source that could be used to facilitate tax cuts elsewhere – going so far as to say they could entirely replace the personal income tax.
- It's silly on the face of it to think that a tax on $3.5 trillion of imports could ever replace a tax on $25.1 trillion of personal income. But it's even worse than that. The whole point of a tariff is to change behavior – to make it so that US consumers don't buy imports, and thus avoid the tariff. So *if a tariff works, it produces no income*. But, hey – if the storyline that tariffs will both change consumer behavior and produce significant tax revenues will allow the 2017 tax cuts to be extended, we'll have to call that one a "noble lie" (see "Video: What you're not hearing about extending the 2017 tax cuts" May 9, 2024).
- Whatever the details, it remains the case that *when we hear about new tariffs we should really think about the whole context of a tax ecosystem* in which tariffs might, in fact, play nicely with offsetting tax cuts. We'll just have to wait and see the particulars.

In the meantime, *here are some things you need to know about tariffs, based on our experience with them in Trump's first term*.

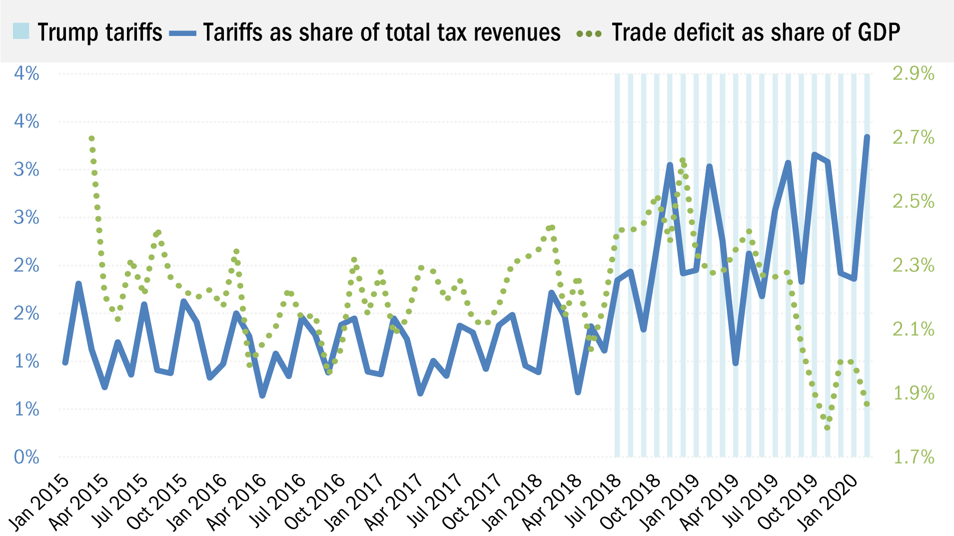
- *At the outset, you need to know how to scale this*. While revenues from tariffs rose starting in July 2018 when Trump began to impose them, *they are in fact a trivial factor in the overall revenue mix for the US Treasury*. As of the most recent data for November, tariffs produced a mere $6.7 billion, 5% of the $301.8 billion collected overall (that is, total – not just the new ones – please see the chart below). It's even worse – $28 billion, or about 4 months of total tariff collections had to be paid out as "trade adjustments" to US farmers harmed by Chinese retaliatory boycotts.

US tax revenues from tariffs (USD billions, monthly)



Source: US Treasury, TrendMacro calculations

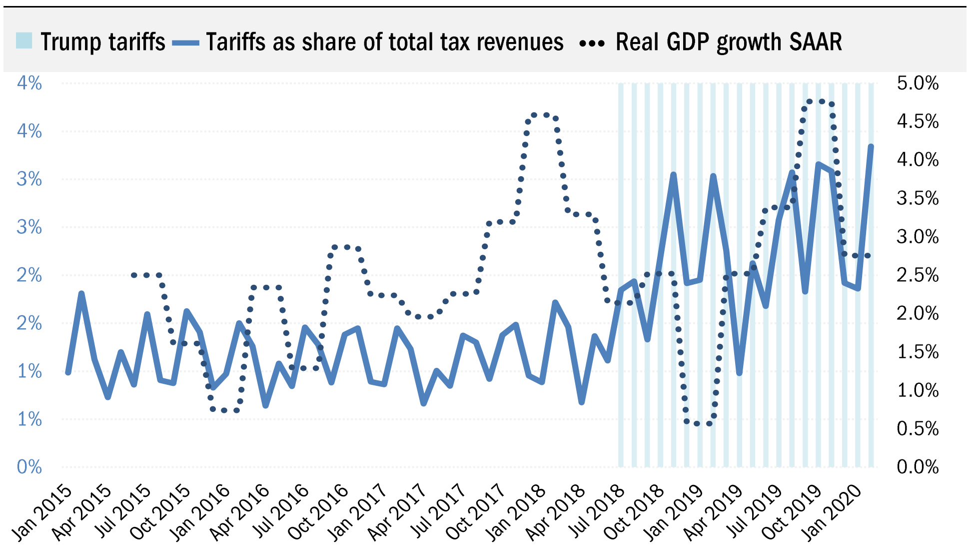
- What can we learn from the small tariffs in Trump's first term? Let's revisit what happened to the trade deficit, growth, the dollar and inflation. In each case we'll start a year before Trump took office and look at the results as a series of tariffs first announced in January 2018 started to collect revenues in July, all the way to



Source: US Treasury, Census Bureau, BEA, TrendMacro calculations

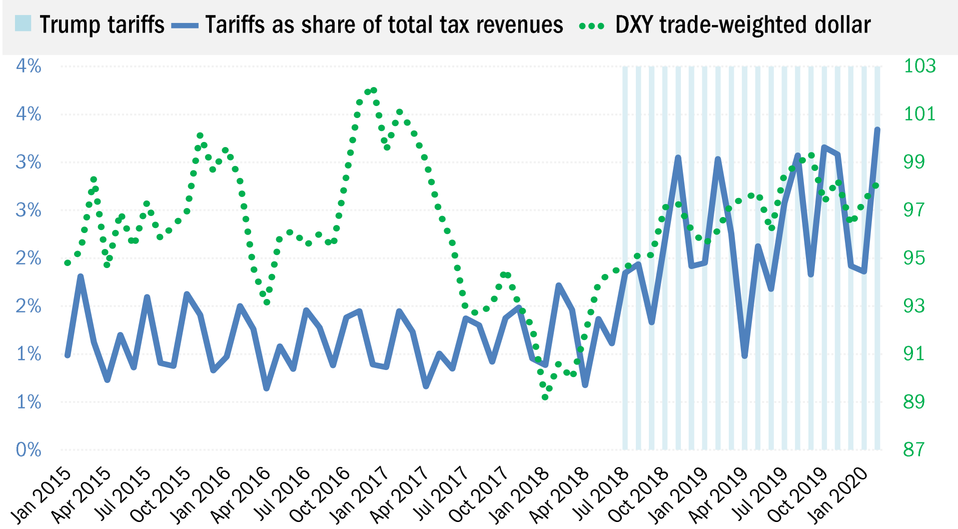
February 2020, the point when all economic data became irrelevant because of the pandemic.

- ***First, the trade deficit***. Reducing the trade deficit was Trump's main reason for imposing tariffs, and at first glance it seems to have worked, at least a little (please see the chart on the previous page).
- But the eye is easily deceived. *On average, the trade deficit at 2.24% of nominal GDP after the tariffs were imposed was worse than the 2.18% average before*. The seeming improvements in the last several months were not materially better than the levels seen in 2016 before Trump was even elected.
- ***Second, growth***. The single worst quarter for real GDP growth during Trump's administration – Q4 2018, at 0.60% at an annual rate – occurred shortly after the tariffs were first imposed (please see the chart below). But Trump's best growth quarter – Q3-2019 at 4.80% – came after further tariffs were imposed. On average, *real GDP growth of 2.69% was precisely the same to two decimal points of precision before and after imposition of the tariffs*.



Source: US Treasury, BEA, TrendMacro calculations

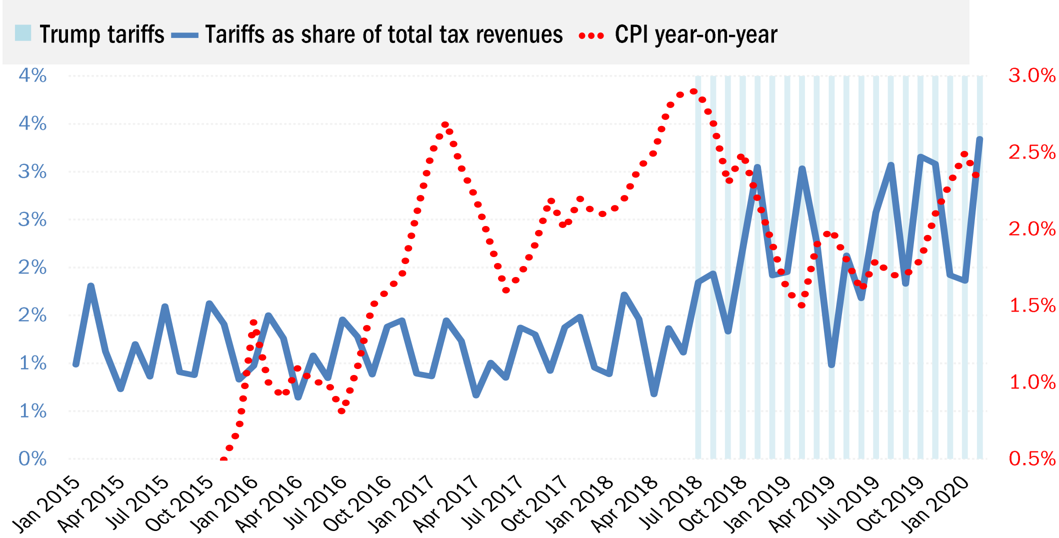
- ***Third, the dollar***. The trade-weighted dollar rose during the period of the imposition of the tariffs (please see the chart on the following page).
- It's plain to the eye that *the dollar appreciated steadily during the period of the Trump tariffs*. Perversely, though, a stronger dollar has the effect of offsetting the tariffs for American consumers (a stronger dollar makes up for higher effective import prices). As a result, consumption behavior doesn't change – which may be why we saw so little impact on the trade deficit. This is an example of what we mean when we say global trade is a self-organizing equilibrium. We suspect theoreticians like Miran would reply that, in fact, what they see as a disequilibrium is institutionally sticky, and requires a much bigger shock than the Trump tariffs of 2018 and



Source: US Treasury, Bloomberg, TrendMacro calculations

2019, or more angles of attack (such as capital controls) brought to bear at the same time, to get unstuck.

- That said, it's not open-and-shut that the strengthening of the dollar during the Trump tariff imposition even means anything analytically. *The dollar's fluctuations before the tariffs to levels both lower and higher than after the tariffs suggest that there's more noise than signal in this analysis*.
- ***Fourth, inflation***. We have long warned against the knee-jerk reaction to tariffs that they are necessarily inflationary (see "Trumponomics II, The Sequel" July 17, 2024). Such a reaction assumes and presumes much – that firms in fact pay more for imports when tariffs are imposed (couldn't importers cut their prices or cheapen their currencies to compensate?) – and if they do, they pass the tariffs on to consumers in the form of higher retail prices –



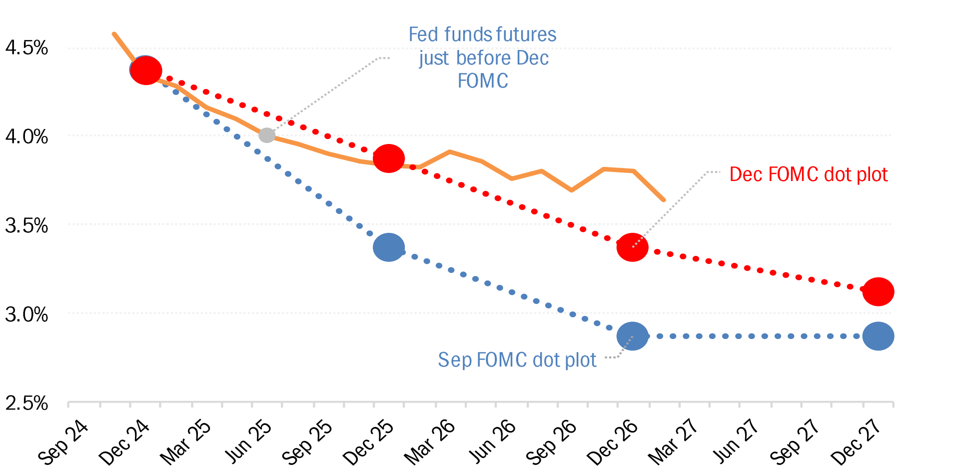
Source: US Treasury, BLS, TrendMacro calculations

and if they do, consumers don't substitute away from the higher-price products (after all, that's the whole point of the policy to begin with!) – and if they don't, the prices of other items don't go down when demand for them falls when consumer budgets are depleted by tariffs? That latter point has been made cogently by Treasury Secretary-designate Scott Bessent.
- The record from 2018-19 is ambiguous. CPI appears to the casual eye to fall after the onset of the tariffs (please see the chart on the previous page). But *it was 1.85% on average before the tariffs, and 2.06% on average after*.

For all this theoretical and empirical doubt that can be cast on the inflationary effects of tariffs, *there is a dominant narrative now that the Federal Reserve believes they are inflationary*, that they will indeed be imposed (not just threatened), and that therefore monetary policy must be kept tighter than otherwise, starting right here and right now. This narrative is drawn out at length in an influential article published last week in the *Wall Street Journal* by our friend Nick Timiraos, the media's top Fed-watcher and a presumed confidante of Fed Chair Jerome Powell (see "Video: TrendMacro conversation with Nick Timiraos on Powell's crisis response and the inflationary aftermath" March 28, 2023).

- It would seem that some narrative like this is necessary to explain the severe year-end correction in equities and back-up in long-term yields began at the December FOMC.
- *It can't be because the Fed disappointed the markets with the funds rate path implicit in their "dot plots," because that didn't happen*. As we pointed out at the time (see "On the December FOMC" December 18, 2024), the FOMC moved its December 2025 prediction for the "appropriate policy rate" to 3-7/8%, implying two rate cuts over the year – which was what the Fed funds futures market anticipated before the meeting (please see the chart below).

Predicted fed funds rate, per FOMC meeting



Source: FRB, Bloomberg, TrendMacro calculations

Indeed, if anything, there was a dovish surprise – the "dot" for 2026 was raised from where it had been in December, but showed another two rate cuts when the market had been expecting only one.

- In the post-meeting press conference, Powell was asked a smart theoretical and hypothetical question about tariffs and inflation:

> "In September 2018 the Fed staff in the Tealbook discussed a policy of looking through any new tariffs as long as they were one-time increases and inflation expectations remained anchored. Could you comment on if that analysis remains effective and any other thinking on tariffs generally that you can share."

- As usual, Powell overshared, with 487 words – including *multiple admissions as to the unknown inflationary effects of tariffs, if any, and admonitions about waiting until we see what tariffs might indeed be imposed*. But maybe the lady doth protest too much – 487 words is too many if all you want to say is "I don't know." And then *he couldn't keep himself from bragging*:

> "…we've done a bit of -- good bit of work, all of us have, each of us has."

- In other words: it's too early to do the work, but we have done the work anyway.
- That makes it not unreasonable for markets to wonder why, if not for fear of tariffs, the FOMC's December Summary of Economic Projections moved up its expectations for core PCE inflation by 20 bp in 2025 and 30 bp in 2026? *And that, in turn, makes it not unreasonable to conclude that the committee is already biasing policy to the hawkish in preparation for tariffs that may never come, and if they do will come in an unknown context, and then may or may not be inflationary*.
- We note that *none of Powell's discussion addresses the elephant in the Fed's room: that is, whether tariffs will be pro-growth or anti-growth?* Wouldn't it make sense to do "a good bit of work" on how tariffs might affect the first of the Fed's mandates – maximum employment – and not just the second – stable prices? The conventional wisdom holds that tariffs are both inflationary and anti-growth. We don't think that will turn out to be right – but if it does, the Fed will be in a lot trickier position than it seems to think now.

So we are left with multiple unknowns:

- Will there be tariffs?
- Will they be inflationary?
- Will they affect growth?
- How will tariffs, if any, interact with other tax changes?
- Will the interactions change the inflationary effects?
- Will they affect growth?
- How will the Fed react?

- Will the Fed react before the fact, or indeed, has it already?

Based on what happened last time, in 2018 and 2019, these would be sensible guesses:

- Tariffs will be threatened.
- Will there be tariffs? Yes.
- Will they be inflationary? No.
- Will they affect growth? No.
- Will the Fed make a mistake? It usually does, but lately it's been doing the right thing by accident.

Bottom line

Trump has surrounded himself with advisors like Miran and Vance who want to reform the global trade "system" by weakening the dollar and potentially giving up reserve currency status. It is not obvious that such status is conferring any benefits. But Trump supports a strong dollar and reserve currency, as USD strength since the election confirms. He wants to use tariffs as both threats to change counterparty behavior and disincentivize imports. Tariffs are just taxes, and changes in them have to be evaluated in context with overall changes to the tax code – including reducing other taxes. The 2018-19 tariff experience shows little discernible effect from tariffs on the trade deficit, growth, the dollar or inflation. The year-end correction in stocks and back-up in yields is driven by a narrative that the Fed believes, despite history, that tariffs are inflationary – and is already adjusting policy tighter in anticipation. Based on 2018-19, tariffs will come, and they won't matter. The Fed's inappropriate reaction is the bigger risk.