

MACROCOSM

Tariff the World. Save the World.

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Trump's "big one" is a game-theoretic optimum in the prisoner's dilemma of trade.

Yesterday President Donald J. Trump announced ["the big one"](#) – he is going to tariff the world, and yet the S&P 500 moved to within a hair of all-time highs. Apparently *Mr. Market thinks this isn't exactly Smoot Hawley* (in 1929, that's what precipitated a history-making crash). Why not?

- We don't accept the narrative we are hearing everywhere that the positive market reaction is due to the fact that the ["reciprocal tariffs"](#) announced yesterday would not take effect immediately. True, all that happened yesterday was a mere ["executive memorandum"](#) instructing various government agencies to make appropriate policies preparations – not an "executive order" to actually implement anything. All this plays a role, *but markets aren't just celebrating a stay of execution.*
- We're also hearing that it could have been worse – Trump campaigned on the idea of a ["ring around the collar,"](#) an across-the-board tariff on all nations. Fair enough, but it's more than that.
- What we're seeing here is not outright protectionism like the [steel and aluminum tariffs](#) announced earlier this week. *This is more like the tariffs announced two weeks ago against Canada, Mexico and China – diplomatic threats designed to coerce concessions. Just threats – with time allowed for other nations to change their behavior to avert them.*
- In this case, the concession demanded is that other nations adopt the free-trade posture of the United States by lowering their tariffs and other non-tariff barriers such as quotas, [phytosanitary conditions](#), currency manipulation, and, arguably, value added taxes.
- Some critics are sniffing that the US threatening to match other nations' higher trade barriers is to [delegate our trade policy decisions to other nations](#), as though we were to that extent surrendering sovereignty. In this instance, why would we want to match their bad policies, and at their whim?
- But all that misses the point. *This is a threat that means we are dictating to them. It means that we are not seeking to match them, but rather to force them to match us. If the threat works, and other nations lower their trade barriers – the way Canada and Mexico have already bowed to Trump's tariff threats by promising to help interdict fentanyl traffic – then this would lead the world into a*

Update to strategic view

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STOCKS: Trump announced "reciprocal tariffs," but it's only an executive memorandum instructing the relevant agencies to make the appropriate policies and preparations, not an actual implementation. This is not the outright protectionism of the steel and aluminum tariffs announced earlier this week. This is more like the tariffs against Canada, Mexico and China two weeks ago, diplomatic threats designed to change the behavior of other nations. In this case, nations can avoid tariffs by lowering their own tariffs. Trade is a prisoner's dilemma, in which both players win by cooperating, but individual players are tempted to win more by defecting. The game-theoretic optimum in an iterated prisoner's dilemma is "tit for tat" – first cooperate and keep cooperating, but punish an opposing player who defects by defecting if he does. This move, which superficially seems like protectionism, could catalyze a golden age of global free trade if other nations recognize the threat and match the US's low trade barriers.

[\[Strategy dashboard\]](#)

golden age of reciprocal free trade. It could be among the most pro-growth developments of our lifetimes.

- Yes, whether it works or not will depend on how other nations respond. That's not in our control.
- But whatever they do – and we can be sure there will be a variety of responses – we think this move is game-theoretically optimal. Tariffs are a perfect real-world example of a “prisoner’s dilemma,” a situation in which both of two players share a payoff if they “cooperate” with each other, but at the same time, in which there is a unilateral excess payoff for one player who “defects,” leaving the other who cooperated with nothing.
- Why shouldn't both players defect every time? Because if they both defect, neither gets a payoff. And in an “iterated” prisoner’s dilemma in which the same players play multiple rounds, there’s no reason to even keep playing.
- You would think the optimal strategy, then, would be to mostly cooperate but then, every once in a while, defect.
- But it turns out that in massive competitive simulations, the dominant strategy is “tit for tat.” You cooperate in the first round, and then in subsequent rounds you do whatever the other player did in the previous round. If he cooperated, cooperate with him next time. If he defected, punish him by defecting next time.
- Trump’s reciprocal tariff idea is the game-theoretic optimal strategy. It is “tit for tat.” We are starting by cooperating (we now have the lowest trade barriers in the world). In subsequent rounds, if another player defects, we will defect.
- What if it works?
- Setting aside advantages to the US by making it easier to export to other nations, such trade liberalization would ultimately be of tremendous advantage to any nation that undergoes it. If trade barriers are bad, then it is other nations that stand to gain more by eliminating them, because it is other nations, not the US, that have the barriers that can be eliminated.
- The ironic outcome might be that a gesture by Trump that seems, on the face of it, to be horrendously protectionist could catalyze a global revolution toward trade liberalization.
- Would it be reading too much into it to note that, year-to-date, the US stock market – while performing quite well – has been outperformed by just about every other nation in the world? That’s not been the usual pattern – but then again it hasn’t been the usual pattern to have a US president whose tariff threats have the potential to lift the other nations of the world out of a generations-long protectionist stupor.
- Wait a generation and – who knows? – Europe might actually invent something. Good for Europe. Good for the world.

We’re still there in our view on tariffs. Wait and see (see, among many, [“Predictions for 2025: Tariffs”](#) January 3, 2025). Tariffs are taxes. Tariffs are threats. Tariffs are complicated (see [“How Much Do Tariffs Matter?”](#) January 28, 2025). Wait and see.

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Remember – AI can be funky. This is still experimental. Check it out and let us know what you think.

Bottom line

Trump announced “reciprocal tariffs,” but it’s only an executive memorandum instructing the relevant agencies to make the appropriate policies and preparations, not an actual implementation. This is not the outright protectionism of the steel and aluminum tariffs announced earlier this week. This is more like the tariffs against Canada, Mexico and China two weeks ago, diplomatic threats designed to change the behavior of other nations. In this case, nations can avoid tariffs by lowering their own tariffs. Trade is a prisoner’s dilemma, in which both players win by cooperating, but individual players are tempted to win more by defecting. The game-theoretic optimum in an iterated prisoner’s dilemma is “tit for tat” – first cooperate and keep cooperating, but punish an opposing player who defects by defecting if he does. This move, which superficially seems like protectionism, could catalyze a golden age of global free trade if other nations recognize the threat and match the US’s low trade barriers. ▶