<u>Thoughts on the Economy</u>
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Update After Trump's Announcement of a 90 Day Pause on Reciprocal Tariffs

I had written a piece that I was planning to send out on April 9, however in light of Trump's terse announcement of a 90 day delay on the reciprocal tariffs, and a 125% tariff on imports from China (later clarified to actually be 145%), I am adding this update.[1]

Equity markets responded very positively to the announcement. One potential very positive outcome would be for China, Canada and the E.U. to drop their retaliatory tariffs in exchange for accepting a 10% tariff on their exports to the U.S., and for the U.S. to have a uniform tariff of 10% on all imported goods. Ideally, the concessions that foreign countries would be making to get the 10% tariff rate would be ones that reduce artificial trade barriers and other market distortions or increase defense spending. If the revenue from the 10% tariff was used to reduce the budget deficit, or to implement tax reforms that increase the labor force participation rate, that could be a positive step toward fiscal sustainability.

Unfortunately, I'm not sure whether the announcement by Trump will resolve the uncertainty, or whether in 90 days we will be back to where we started or even worse. The negotiations regarding reciprocal tariffs could fail if the administration is serious about including VAT as a non-tariff barrier that needs to be eliminated. Many countries depend on VAT as a major source of revenue. Elimination of VAT would be a fiscal disaster for the countries in the EU and for many other countries as well. Other non-tariff barriers include prohibiting the importation of genetically modified goods, or beef with hormones, or chickens that are washed with chlorine. It seems unlikely that the trade negotiators would have the authority to implement these changes to non-tariff barriers, and I'm skeptical that the relevant authorities would eliminate these non-tariff barriers within the 90 day pause period. Any deal that depends on the elimination of non-tariff barriers seems unlikely to reduce uncertainty.

I'm also not sure how China will respond. There is a widely held perception that the Opium Wars were a means of addressing the trade imbalance between China and Great Britain by forcing China to open its markets to importation of opium from India. This history will presumably make China exceptionally sensitive to U.S. pressures to address trade imbalances.

[1] It was unclear from President Trump's posting on Truth Social whether the 90 day pause, and the uniform 10% reciprocal tariff applies to all countries other than China or only to countries that have not retaliated. This may be irrelevant since countries that have retaliated are likely to roll back the retaliatory tariffs during the 90 day pause.

The pessimistic outcome would be that China retaliates by cutting off exports to the U.S. of refined minerals and other inputs that are needed for the production of batteries and other electronic equipment, and imposes secondary boycotts on countries that re-export those inputs to the U.S. China could also retaliate by announcing that it intends to dump its holdings of U.S. bonds and use the cash to stockpile metals and minerals that are used in the production of high value added goods.

Another issue to consider is what would be the consequences of Trump succeeding in eliminating our imbalances in the trade in goods. The balance of payments roughly balances.[2] If the U.S. doesn't run a deficit in goods and continues to run a surplus in the provision of services, then it must run a deficit in the capital account (the laws of arithmetic are not negotiable). It seems unlikely that the U.S. can substantially reduce its surplus in the provision of services in the foreseeable future.[3] A deficit in the capital account means that foreigners will be net sellers of U.S. assets, and will be cutting back on investments in the U.S.

The material below should be taken as thinking about what would happen if 90 days from now, we are back where we were prior to President Trump's posting on April 9. To some extent the text below applies even if reciprocal tariffs remain at 10% but the current levels of tariffs on China and on imports of steel, aluminum and cars remain in effect.

Impact of Previously Announced Tariffs on the Economy

Even before "Liberation Day" when tariffs were announced, and we were liberated from ????, there were very negative sentiment readings from the University of Michigan Survey of Consumers and surveys of small business owners. The sentiment readings clashed with the hard economic condition data, which was not nearly as bad. Under current conditions I would place more weight on the sentiment data. The hard data is somewhat backward looking. Firms and households were stocking up in anticipation of higher prices—the surveys found jumps in inflation expectations that were far in excess of what markets were predicting. Firms are likely to be increasing production prior to increases in their costs of inputs. The strong jobs report for March despite a small uptick in unemployment may be due to firms increasing their use of part-time workers and offering short duration jobs at a fairly high wage, causing an increase in the number of workers with multiple jobs despite an increase in the percentage of unemployed workers. Perhaps firms didn't want to commit to hiring and training more long-term employees but did want to increase inventories prior to price increases for their inputs.

[2] The reported balance of payments only roughly balances because some transactions and transfers of funds such as the sale of illegal drugs, or the theft of crypto currencies are not included in the data used to calculate the balance of payments.
[3] With the exception of tourism, demand for U.S. services (for example revenue from intellectual property or financial services) seems unlikely to change much.

The greatest harm from the tariffs announced on April 2 is the increase in uncertainty. The first level of uncertainty is whether the tariffs will withstand judicial review. There are multiple grounds for challenging the tariffs. The President has invoked the International Emergency Economic Powers Act ("IEEPA") as the basis for his ability to impose tariffs. The first sentence of the IEEPA reads as follows:

> Any authority granted to the President by section 203 may be exercised to deal with any ***unusual and extraordinary threat*** [emphasis added], which has its source in whole or substantial part outside the United States, to the national security, foreign policy, or economy of the United States, if the President declares a national emergency with respect to such threat.

Since the President has said that the trade imbalances justifying the tariffs have been going on for 40 years, they would not seem to constitute an "unusual and extraordinary threat."

The courts may also be concerned that the processes for providing sufficient notice under the Administrative Procedure Act were not followed. There is also an issue about whether the Congress can abrogate its constitutional duty to levy tariffs, or whether that would require a constitutional amendment. I am not an expert on constitutional law, but there would appear to be enough uncertainty about how the courts might rule that as an investor I would be cautious about making investments based on an assumption that these tariffs will or will not be sustained by the courts.

Aside from special considerations such as the goods imported from Canada and Mexico under the USMCA, most tariffs are levied according to the substantial transformation rule. Consequently, there are strong incentives to relocate final assembly to countries that are subject to the lowest tariff level and are likely to keep that low tariff rate even if they start exporting more goods to the U.S. (The administration has not announced how frequently the tariff rates for individual countries will be recalculated.) Countries that currently qualify for the 10% minimum tariff on exports of goods to the U.S. include the U.K., Singapore, Turkey, Australia, Costa Rica, Brazil, and Argentina. If producers move final assembly to avoid tariffs, it is not clear how the U.S. will respond. Being wrong about whether the final assembly is determined to be a "substantial transformation" could be very costly to U.S. importers of the product. These issues will impose additional uncertainty on the cost structure of firms and where they should source inputs. This should cause firms to become more cautious about making investments until they get a better understanding of the cost of their inputs and the effect of the tariffs on the prices of imported consumption goods. Similarly, retailers will presumably delay making large purchases until they understand what the prices of these goods today versus in the future will be. Since the producers of these imported goods will be responding to the ways in which tariffs are enforced and the responses will take time to be implemented, even if the tariffs are unchanged, the effective tariff rates could be in flux for quite some time, leading to delays in investment.

The uncertainty will be exacerbated if the tariff levels are subject to renegotiation (either up in the case of China or perhaps down for other countries that make concessions to the administration). The administration has said that tariffs will be changed if there is a "phenomenal deal." Presumably there is uncertainty about what would qualify as a phenomenal deal. Did the USMCA qualify as a phenomenal deal? If so is that the benchmark firms should be using to predict future tariff rates?

If firms and consumers retrench in response to the heightened uncertainty about the economy, there could be a severe recession. If the recession is also accompanied by price increases, the Fed may not cut interest rates—in my conversations with a former Fed governor, he stressed that he didn't think the Fed would want to be seen as bailing out bad policies. That would create serious moral hazard problems. I'm also somewhat dubious about the ability of the Fed to avert a recession by cutting interest rates. A cut in the federal funds rate from around 5% to basically zero did not end the Great Recession of 2008-2009; nor did 7 years of sub-zero interest rates in Europe from 2015-2022 enable Europe to avoid anemic growth rates.[4]

For consumers, a main effect of cuts in short-term interest rates (which is what the Fed is targeting) is on the demand for motor vehicles, because these purchases are typically made with financing, the cost of which is linked to short-term rates. During the Global Financial Crisis, the demand for motor vehicles fell dramatically despite large cuts in interest rates. The increases in the costs of producing cars due to tariffs and macro-economic uncertainty which discourages large purchases makes it unlikely that the Fed will be able to stimulate motor vehicle sales sufficiently to avert a major recession.

The other sector that is sensitive to interest rates is home building. Here the sensitivity is to mortgage rates, which are affected by longer term interest rates. Deportations of illegal immigrants (who are disproportionately employed in residential construction) and tariffs are going to increase the cost of home construction. The continued unwinding by the Fed of its holdings of mortgage-backed securities (by up to $35 billion per month) is likely to keep mortgage rates high relative to other interest rates, so I don't see a path through which large increases in home building provides enough stimulus to avert a recession.

Who Pays for Tariffs

Poorer people spend a large percentage of their income on goods vs. services, and the higher tariffs will also cause price increases in domestic goods that face less price pressure from imports. Therefore, they are especially vulnerable to the adverse price effects of tariffs. Social Security recipients and the disabled have their benefits linked to the CPI. They are protected from increases in medical costs through either Medicare or Medicaid. In the case

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[4] OECD, Interest Rates: 3-Month or 90-Day Rates and Yields: Interbank Rates: Total for Euro Area (19 Countries) [IR3TIB01EZM156N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/IR3TIB01EZM156N, April 9, 2025.

of Social Security recipients, they disproportionately live in owner occupied housing or in facilities paid for by Medicaid and thus increases in rents increase their benefits (which have a roughly 1/3 weighting to rents) without increasing their costs. Offsetting these considerations is the lag between when prices rise and when Social Security and disability benefits adjust.[5]

The other group that may suffer from tariffs is exporters. If we ignore changes in capital flows and other macro-economic effects, we would expect the demand for U.S. exports to fall (foreigners will have fewer dollars to use to buy our exports). We would expect that the net effect will be a decrease in the trade deficit, which would be offset by a decrease in our capital account surplus (the balance of payments balances with some slack due to errors and omissions). A decrease in the capital account balance means less purchases of U.S. assets by foreigners. These adjustments affect the foreign exchange rate and in return the foreign exchange rate affects the cost of imports and thus the trade balance. The changes in the capital account affect asset prices (both financial and real), interest rates and wages.

Thinking about financial flows is likely to give you a headache. Let me try to lead you through it with a very stylized example. Suppose we are buying goods from Europe, because they are either better or cheaper than what we can produce here. The Europeans are buying equities in the U.S. because they think returns on equities will be higher here or because of greater liquidity in our markets—I warned you that this is highly stylized, but bear with me. We need to pay for the European goods with euros, so we are using our dollars to buy euros. This pushes up the price of the euro relative to the dollar; the Europeans need to pay for their purchases of equities with dollars, so they are using their euros to buy dollars. The exchange rate of dollars for euros is a function of the demand by the U.S. for euros to buy imports and the demand by the Europeans for dollars to buy U.S. equities.

Now the U.S. imposes this patchwork of tariffs. There is less demand by the U.S. for imports which means less demand to buy euros by U.S. consumers, but the foreigners may also think this policy is bad for U.S. growth and thus will be selling their holdings of U.S. equities and converting those dollars into euros, increasing the demand for euros. The relative magnitude of the decreased demand for euros by consumers of imports from the euro zone, and the increased demand for euros relative to dollars by investors, will cause the exchange rate to adjust to a level at which these relative demands equilibrate. Of course, this is highly stylized; in practice the central banks and treasuries of countries intervene both directly and indirectly in the foreign exchange markets and influence the exchange rates. And of course the U.S. investors also purchase foreign assets, and foreigners are purchasing goods and services from the U.S., but we are net purchasers of goods and services from foreign producers and they are net purchasers of U.S. securities—including government bonds as well as equities and corporate bonds. To a lesser extent, foreigners are investing in physical

[5] Benefits adjust in January, and the change in benefits is linked to the change in the CPI from the 12 months ending the previous September.

assets including factories and homes and U.S. firms and consumers are investing in physical assets outside the U.S. All these transactions as well as expectations regarding future transactions influence the exchange rates.

As the example illustrates, estimating the net effects of tariffs involves attempting to predict how investors would perceive the future returns on dollar denominated securities in this new environment. It also entails estimates of how quickly the workers and firms will adjust to the changes in relative prices. Note that thus far the trade weighted exchange rate has fallen, which suggests that foreigners are not very sanguine about how these policies will affect returns on investments in the U.S.

Most commentators are opining on the *probability* of a recession. I have done that as well. I apologize. When someone gives a *probability* of something happening, they can't be wrong. A prediction about the probability of a unique event is not falsifiable. What is falsifiable is a prediction about the future growth rate. I think real (inflation adjusted) annualized growth for the 6 months starting April 1, will be between +1% and -5%. This is much more pessimistic than the consensus. My view would change significantly if the patchwork of tariffs were replaced with legislation for a uniform tariff on all imports. Legislating the tariffs would reduce uncertainty about the cost of imports relative to domestically produced goods and the uniform tariff would decrease the dead weight loss from distortions in relative prices.

Uncertainty About Where Tariffs Will End Up

In trying to predict the eventual level of tariffs, one might model the interactions of the decision makers as a game (I'm using game in the technical sense of a mathematical model of behavior in which each participant is choosing its best strategy, given its beliefs regarding the strategies of all the other participants). Unfortunately, to know what the best strategy is we need to know the preferences of the participants. The participants are people, not countries or firms (no one ever met a country or a firm). The leaders of countries may have preferences that are at odds with what economists would think would maximize welfare for their constituents. Voters do not necessarily vote for what is in the national interest, or even what is in their own personal self-interest. Rather, they may be using their ballot to make a statement to assert and confirm their values, and to respond to social pressures from friends and family. Juan and Eva Peron are folk heroes in Argentina—the Peronism movement as represented by the Union for the Homeland is the largest coalition in the Argentinian parliament—even though they are arguably responsible for the large decline in the economic performance of Argentina over the last 80 years.

What does this mean for the future economic health of the U.S.? I don't presume to know the preferences or beliefs of the people making decisions about tariffs—I have enough trouble trying to figure out what is in my own self-interest. I suspect that people who presume to know the preferences of others are fooling themselves. But even if preferences were known to predict the outcome of these negotiations you would also need to know the beliefs the relevant decision makers had about the preferences of other leaders and about their beliefs and so on. This would seem to be impossible. Thus it would seem that we are going to have to live with uncertainty for quite some time. I would therefore be cautious about making large irreversible investments that entail directional bets on macro-economic conditions.

Sincerely,

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