Ten Seconds Never Felt So Long. 2025 Trade War.

The US economy a year ago was experiencing strong growth from the momentum of a fiscal impulse as well as expectations of rate cuts, of which we got 3 beginning in July. Did the US economy need rate cuts? Probably not on the strength of coincident data at the time. But from the perspective of refinancing corporate debt, which would extend the impact of the rate hikes of 2022/23, the economy probably did need them. By early 2025 it was clear that while inflation was moderating, it was not falling to pre-COVID levels. At the same time, growth indicators were beginning to slow, if modestly. For the US economy to maintain its growth trajectory, the Fed would have had to thread a fine line of well-timed and sized rate cuts through 2025 and beyond.

The trade war initiated by President Trump has changed the landscape for the Fed. Tariffs are inflationary but the impact is likely to be an initial sharp step up. Thereafter, things are less clear. If the economy slows, as one might reasonably expect, inflation pressures will ease. On the other hand, a new trade equilibrium exacerbated by potential labour shortages, tariff escalations and supply chain disruptions is likely to be inflationary. The net impact on inflation is hard to guess.

The impact on output is a bit clearer. Consumer confidence will be further impaired and consumption is 67% of GDP. Investment, 18% of GDP, will likely fall sharply as corporate investment plans are halted by uncertainty. The 18% of government spending will likely be constrained by the already increasing fiscal deficit, compounded by rising funding costs unless rates are cut aggressively and the yield curve is cooperative and doesn’t steepen sharply. The current account deficit will probably shrink sharply as trade shuts down.

On balance, the odds are that inflation remains elevated while output slows and probably shrinks. The thankless job of monetary policy would encourage rational Fed officials to find other vocations.

Economic forecasting is difficult enough when geopolitics is a continuous diffusion. When it is a series of discontinuous changes in direction or pace, forecasting is impossible. One has to get the geopolitical outlook right before one can make inferences about the economic impacts.

Trump intends to achieve net zero trade balances on a pairwise basis with all trading partners. Is this useful? That’s not the relevant question. Is it practical? Also not very relevant. Will he go for it? Very relevant. Answer? Don’t know. Best guess, he will go for it.

Much depends on the response of the various trading partners. If they retaliate then one can expect Trump to escalate. If they back down and negotiate, the risk of non-tariff conditions rears its head. The US believes itself capable of self-sufficiency and with the development of fracking and shale oil, they nearly are. Nearly, because they still need immigrants.

One can only hope that trading partners choose not to escalate. Too late; China has called (+34%) and Trump has raised (+50%). A less ambitious hope is that America’s trading partners at least do not turn on one another and decide to restore some normalcy to global ex-US trade. There are some signs of this. The EU has refrained from tariffs on bourbon, wine and dairy products and has reached out to China to coordinate the management of trade diversions resulting from the American tariffs. Still more needs to be done to prune tariffs and non-tariff barriers to trade. The business lobby in the US will be a significant actor. This constituency had cosied up to Trump during his campaign and pre Liberation Day in an effort to either gain favour or influence policy. That strategy has not paid off. With global supply chains as integrated as they were, US business has every interest in lobbying for some tariff relief and orderly industrial policy. Until they succeed, corporate investment, almost a fifth of US output, will be on hold.