A possible road map of Trump's gambit

CAPITAL CONTOURS

BY RAY CHOY

News on tariffs continues to dominate headlines after US President Donald Trump's return to the White House following a decisive election victory. However, tariff policy needs to be analysed within a broader framework, beyond a reductionist view of protectionism. This approach leads to a better understanding of the tools that the US government — as a global institution and beyond Trump's emanations — might employ within a global trade war. A second goal of this article is to link a sequence of potential financial market reactions to complement the macroeconomic discussion.

Fundamental economics defines tariffs as a tax on goods, which became a primary concern when financial markets reacted to talk of US tariffs following Trump's election in November 2024. A tax on goods raises inflation, which in turn reduces a central bank's ability to lower interest rates. Future interest rate cuts have been anticipated since the beginning of 2024, and the weakening of this expectation dampens market sentiment, resulting in capital outflows from emerging markets. Despite this, the US Dollar Index appreciated by 6% to a peak of 110 in January but has since depreciated 4% at the time of writing. This leads to the question: why the trend reversal in the Dollar Index?

The trend in the Dollar Index represents the typical sequential bifurcation of market reactions, more commonly known as peaks and troughs, or bulls and bears. Initially, financial markets accounted for the theoretical expectation that higher inflation caused by tariffs would reduce imports, thereby decreasing the size of the US trade deficit with the rest of the world. While the initial reaction as such is theoretically correct, it is only applicable over a limited period, which at the extreme end is considered a static model. Over time, the dynamic reaction function of the trade war will remain an iterative process until several rounds of the pro-tariffs thesis statements are countered by anti-theses.

In the present phase, financial markets have begun to factor in retaliatory measures by countries impacted by US tariffs, hence the decline in the Dollar Index. So far, China has imposed tariffs of up to 15% on major US farm exports, while Canada imposed 25% tariffs on US goods. These retaliations were in response to US tariffs of 10% on China in February, followed by 20% in March, and the 25% tariff on Canadian goods. Mexico is also engaged in a similar battle with the US. The retaliation from these countries would then result in a partial withdrawal of these tariffs, either by amount or by a temporary suspension. Therefore, the decline in the Dollar Index and US Treasury yields is likely linked to the offsetting effect of retaliation against US tariffs. In other words, retaliation could lead to future US and global demand destruction, lower US exports, reduced imports by the US due to higher costs and limited progress on reducing the US trade deficit.

In the next sequence of events, the financial markets will likely envisage a limit to lower US demand destruction and the degree to which this specifically affects US economic growth. As with most trade wars, demand destruction occurs with a decline in total trade, first between direct trade partners, before spilling over to regional economic blocs and global trade. In a world without trade protectionism such as tariffs, economies maximise output potential through competitive and comparative advantage — being able to produce more efficiently, optimally and with better quality. In a world with protectionism, total output declines akin to a rent-seeking setting caused by a trade barrier. Here, the US administration seeks the rent of political capital since tariffs endorse Trump's "America First" policy in an act of economic nationalism and, by extension, broad, populist support. The cost being imposed on the entire population and economy here entails the conversion of economic value to political capital and, as such, this value is less broad-based and optimal since it accrues to Trump's administration and is less representative of the nation's general economic preferences. Furthermore, this cost is not just borne by a single nation but by the world as total global trade declines.

Given the global economic cost of trade wars, financial markets will likely revert to US dollar strength and lower US Treasury yields as part of a safe-haven trade strategy. However, a complex calculus is the extent to which gross domestic product, or GDP, growth has to decline before safe havens are once again in fashion. Today, pundits have begun to formulate possible scenarios of a US recession and what this means for growth in emerging markets. Should this occur, the US Federal Reserve may very well accelerate interest rate cuts on terms that are not its own.

The other scenario which could play out is not one of an evenly distributed decline in global growth, but one in which US growth is damaged more significantly versus the rest of the world due to multiple retaliatory actions, specifically against the US in the global trade war. This may be one scenario which provides a perverse reason for the US to take drastic institutional measures such as a Plaza Accord-style deal, potentially one conceived in Trump's Mar-a-Lago resort. In such a deal, Trump would seek a devaluation of the US dollar through coordinated efforts with trade partners, potentially by dangling the bait of ending the trade war. Notwithstanding the plausibility of such a deal due to the current state of US international relations, such an institutional measure remains a loud sabre-rattling tactic that Trump can employ, and one sufficient to depreciate the US dollar, an original intent of Trump. Consequently, the pathway of the US dollar and its impact on all other currencies remains murky without an appreciation that the current trade war goes beyond macroeconomic stakes.

The political nature of Trump's gambit suggests that he is seeking specific geopolitical concessions. This is evidenced by the framing of tariffs as a national emergency with the highly emotive issue of the fentanyl crisis through China's supply chain and drug trafficking with US' southern neighbour. In response, policy options from the perspective of other nations would then include the possibility of providing the appearance of being pliable to Trump's aggressive foreign policy. Additionally, this could include shrinking China's geopolitical ambitions, while most nations would likely aim to diversify from China-US bipolarity. On this point, the US has created the narrative of being concerned over China's technological ambitions and China has partially sidestepped this issue by targeting tariffs on a less touchy issue, namely agriculture-related tariffs.

Ultimately, it is ironically possible that Trump might seize the opportunity to address the damage caused by the trade war he initiated, blaming China as the perpetrator, and subsequently easing protectionist measures to usher in a "new" era of free trade at the start of a growth cycle. A similar pattern is emerging in international relations, where the US withdrawal from the Ukraine geopolitical effort grants Trump strategic flexibility to delay military provisions until a more opportune moment — potentially after Germany has strained its financial and military resources. These outcomes then provide Trump the headroom to exercise significant economic and geopolitical leverage in the future. E

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