Pablo Fajgelbaum and Amit Khandelwal

Tariffs in 2025: Short-Run Impacts on the U.S. Economy*

Discussion by

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Summary

- Excellent paper, snapshot of how trade field evaluates tariffs
  - rigorous assessment and balanced academic view of tariffs
  - using cross-sectional variation in trade values and prices

- Larger than previous tariff shocks, but still a small shock:
  - 7.2% tariff * 10.8% imports-to-GDP = 0.8% of GDP shock
- Near-complete pass-through: 90%
- Small welfare effects: approx 0.1% of GDP
- Large redistribution:
  - from firms and households to government, 0.8% of GDP

- Determinants of tariffs: China + bilateral deficits + random variation

Methodology

- Cross-sectional variation + partial equilibrium model
- Works well for heterogenous tariffs with a small average tariff

- Aggregate effects go into the **intercept** (time fixed effects)
  - monetary policy
  - **exchange rate** and assets prices
  - trade / current account deficit
  - investment and FDI (LR adjustment to GVCs)

- Direct versus **indirect effects** of tariff announcement
  - expectations and beliefs
  - intangible productivity, e.g., of financial sector – parallel with Brexit

Exchange Rate

$$\Delta \log RER = \frac{\sigma}{\sigma + \sigma^* - 1} \Delta \tau^I \approx \frac{1}{2} \Delta \tau^I$$

- needed to attain new equilibrium (e.g., trade balance)
- Valuation effect on asset position = wealth transfer abroad:

$$= \text{USD External Liabilities} \cdot \Delta \log RER \approx 175\% \text{ of GDP} \cdot 3.5\% = 6\% \text{ of GDP}$$

- Data: substantial devaluation?
  - requires additional shocks

USD Exchange Rate

Loss of privilege

(Itskhoki and Mukhin 2026)

$$\underbrace{-\sum_{t=0}^{\infty} \bar{R}^{-t} NX_t}_{\text{permanent trade deficit}} = \underbrace{\bar{R}\mathcal{B}_{-1}}_{\text{⓪ exogenous initial NFA}} + \underbrace{(\mathcal{R}_0 - \bar{R})\mathcal{B}_{-1}}_{\text{① on-impact valuation effect}} + \underbrace{\sum_{t=1}^{\infty} \bar{R}^{-t}(\mathcal{R}_t - \bar{R})\mathcal{B}_{t-1}}_{\text{② future excess returns}}$$

1. tariff leads to a **retrenchment** of portfolio positions ($\mathcal{B}_t \downarrow$) (endogenous loss of privilege)

2. this is not enough to cause a USD depreciation

3. if a tariff shock triggers a "**loss of convenience yield** on US assets" shock ($\mathcal{R}_t \downarrow$), this can cause a USD depreciation

US yields and dollar have parted company

Rising US yields typically support the dollar, as do geopolitical tensions (as the dollar is often seen as a haven asset). Since Donald Trump unleashed his trade war, however, US yields have soared and the dollar has plunged.

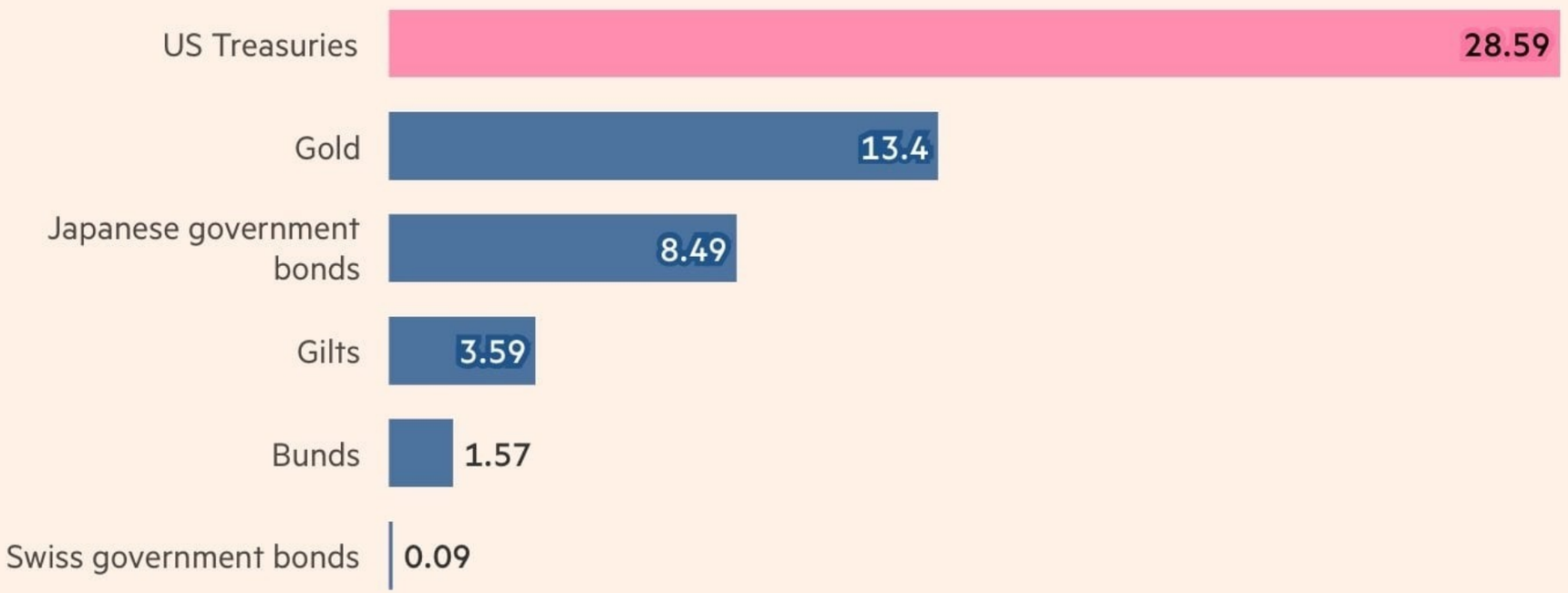
The dollar usually moves in lockstep with US yields... until 'liberation day'

Asset Prices and Portfolio Flows

- Melt-down of the stock market, followed by quick recovery
- Also reversal of the increased Treasury yields
- But: **no** reversion in the USD
- Loss of privilege for the USD, not US assets
- Would this be followed by retrenchment from US assets as well?

US Treasuries are a much larger market than other haven assets

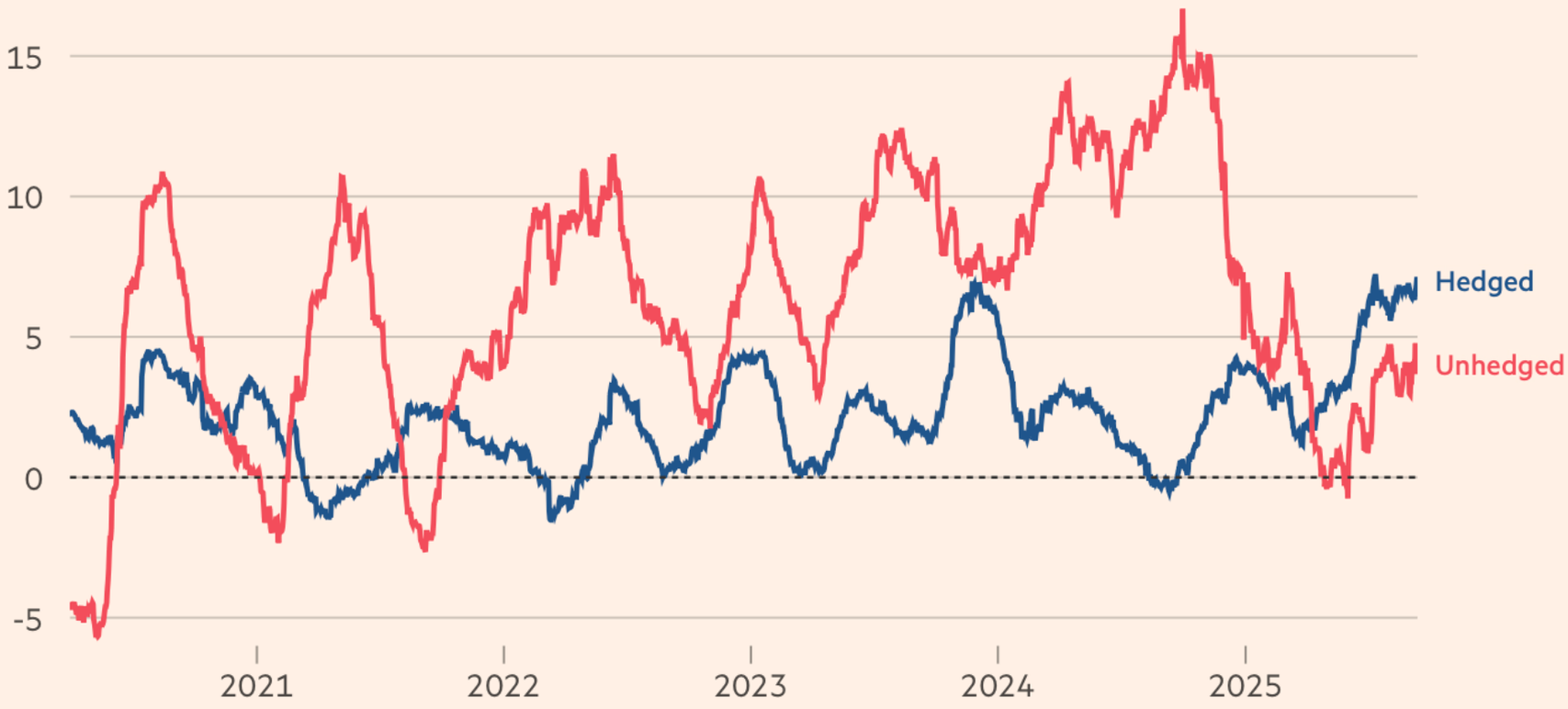
Market size ($tn), by asset



Source: US Department of the Treasury, Japan's Ministry of Finance, UK Debt Management Office, Deutsche Bundesbank, Swiss National Bank, World Gold Council, FT calculations • US Treasuries include all marketable Treasury securities outstanding. Gold refers to total above-ground stock, including bars and coins, gold-backed ETFs, central bank holdings, and other forms, excluding jewellery. Bond values are converted using exchange rates on Apr 30, and gold is estimated at $3,500 per ounce. Data as of Mar 2025 for US Treasuries and Swiss government bonds; Apr 2025 for gilts and bunds; and Dec 2024 for gold and JGBs

Hedged ETF flows into US assets now surpass unhedged

Foreign-domiciled ETF inflows into US assets



FINANCIAL TIMES

Source: Deutsche Bank Research, Bloomberg Finance

Optimal Terms of Trade Manipulation

$$\tau^I = \frac{1}{\sigma^* - 1}\frac{1}{\Lambda^*} \approx \frac{1}{\sigma^* - 1} \approx 66\%$$

- likely long-run $\sigma^* \gg 2.5$
- why terms-of-trade effects so miniscule in the model?
- GE ToT cannot be picked up from cross-sectional regressions, as it operates via aggregate relative costs (e.g., real exchange rate)

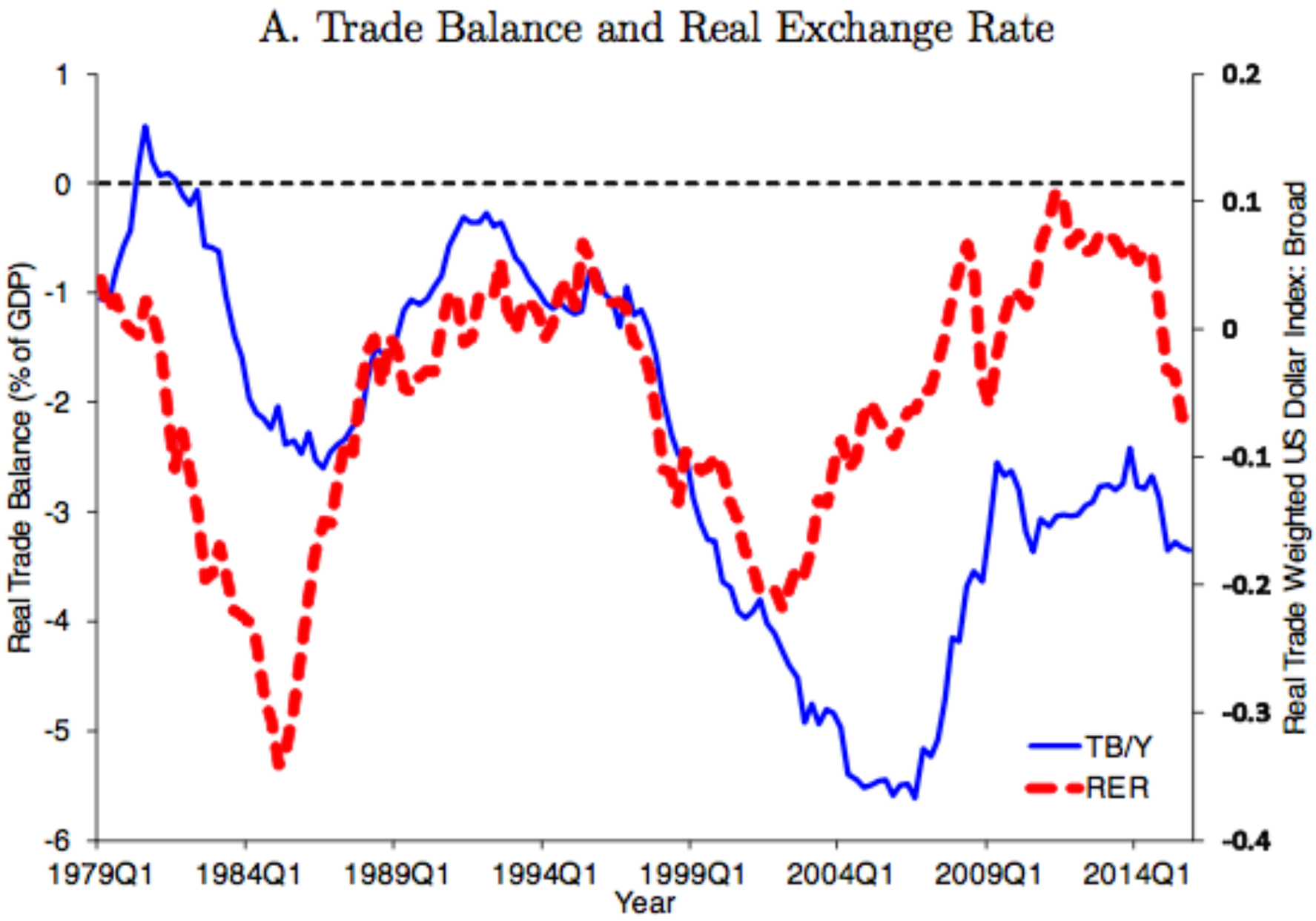
Deficits

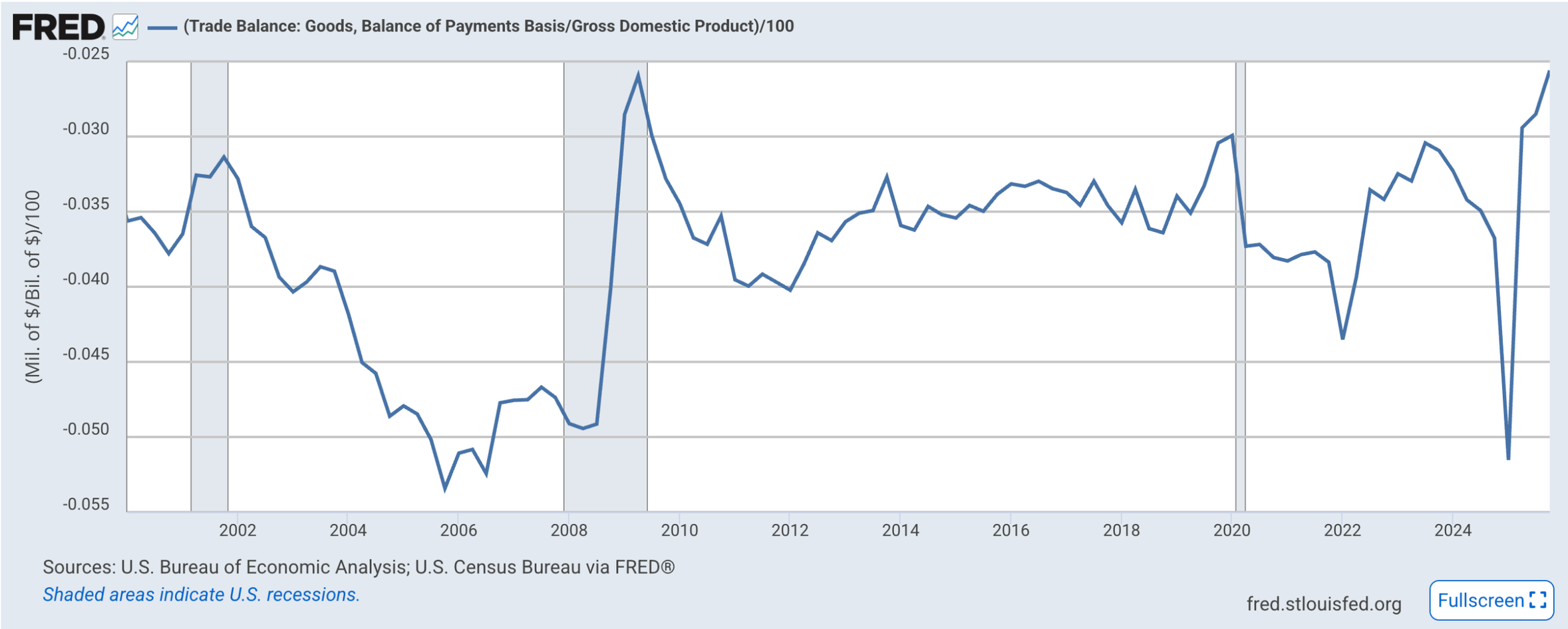
- Wealth transfer via valuation effect and loss of privilege can reduce trade deficits

- “Mar-a-Lago accord”: dissipate the reserve status of USD
  - would it lead to Plaza-accord-like adjustment?

- Effects on aggregate investment and savings
  - GE consequences for trade

- Data: return of trade deficits >3% GDP in December 2025?


A. Trade Balance and Real Exchange Rate
Real Trade Balance (% of GDP)
Real Trade Weighted US Dollar Index: Broad
1
0
-1
-2
-3
-4
-5
-6
0.2
0.1
0
-0.1
-0.2
-0.3
-0.4
1979Q1
1984Q1
1989Q1
1994Q1
1999Q1
2004Q1
2009Q1
2014Q1
Year
TB/Y
RER


FRED
(Trade Balance: Goods, Balance of Payments Basis/Gross Domestic Product)/100
(Mil. of $/Bil. of $)/100
-0.025
-0.030
-0.035
-0.040
-0.045
-0.050
-0.055
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
2022
2024
Sources: U.S. Bureau of Economic Analysis; U.S. Census Bureau via FRED®
Shaded areas indicate U.S. recessions.
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Manufacturing Employment

- Even if deficit is reduced, manufacturing employment is likely to decrease
  - job created in import-substitution do not offset export jobs lost

- FDI: employment and CA deficit – conflicting goals

- Question: why protectionism now, during a period of lowest unemployment, and not during jobless recovery after GFC?


FRED
All Employees, Manufacturing
Thousands of Persons
13,000
12,800
12,600
12,400
12,200
12,000
11,800
11,600
11,400
11,200
2017
2018
2019
2020
2021
2022
2023
2024
2025
2026
Source: U.S. Bureau of Labor Statistics via FRED®
Shaded areas indicate U.S. recessions.
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