Global and Strategic Issues:

Implications for Monetary and Fiscal Policy

Introduction

Power and Prosperity—Brief Remarks on Economics and National Security

Ross Levine

Military and economic power are inextricably linked. This is not a new idea. Around 400 BCE, the Greek historian Thucydides observed: "War is not so much a matter of arms as it is of money."[1] After helping to lead the United States to victory in World War II, Dwight Eisenhower (1952) argued, "The foundation of military strength is economic strength."[2]

Other leaders have further emphasized that trade is vital for forming peaceful alliances that strengthen national security. For instance, writing around 380 BCE, Isocrates (1929) implied that Athens made the Piraeus a common market, so that by exchanging goods we might all live in peace with one another. Focusing on building strategic alliances through economic integration, President Harry Truman (1946) explained:

> The foreign economic policy of the United States is designed to promote our own prosperity, and at the same time to aid in the restoration and expansion of world markets and to contribute thereby to world peace and world security.

President Truman and all his successors—except for President Donald Trump—established and expanded a vast network of international institutions that have lowered barriers to global trade, direct investment, and financial flows. The goals were clearly articulated: Freer, more competitive markets would generate long-term economic benefits for the United States and its economic allies, and these allies would form a strategic alliance against Communism and other adversaries.

The success of this US strategy—and the broader lessons from history—led former US secretary of defense and current Hoover Institution fellow Jim Mattis (Myre and Inskeep 2019) to argue: “Throughout history, we see nations with allies thrive, and nations without allies wither.”

Consequently, history raises important questions about the future of US economic power and national security in light of recent US policy initiatives.

The Inseparable Connections Among Economic Policies

Just as military power and economic prosperity cannot be effectively examined in isolation, so too must we consider individual economic policies as part of an integrated economic system, where adjusting one policy lever will reverberate throughout the economy, impacting other national policies.

Consider international trade. An overwhelming amount has been written about US trade policy since President Trump took office. Although US trade policy is a critical issue, tariffs have effects that extend well beyond the domestic winners and losers created by those policies. For instance, we know that international capital surpluses reflect trade deficits, raising questions about the impact of tariffs on capital markets. Specifically, trade policies that cut the trade deficit are likely to increase the cost of US federal debt, raise the expenses that US firms incur for financing capital investments, and elevate the costs for US households borrowing to buy homes.

Moreover, trade policy reforms that increase the costs for the government and firms in securing capital can impede growth and elevate fiscal deficits, expediting the moment when we must address our fiscal debt burden.

Economics is a national security issue, and analyzing individual economic policies in isolation constitutes a serious mistake that can lead to policies that hinder growth, prosperity, and security.

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[1] Translation by Richard Crawley in *The Landmark Thucydides*, edited by Robert B. Strassler (Free Press, 1996).

[2] See Eisenhower (1952). This was published by the *New York Times* as "Text of Eisenhower Address on 'Famine or Feast' Defense Policy," September 26, 1952.

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Unalienable Rights and Unbridled Entrepreneurship: Maintaining the Free World's Competitive Advantages

H.R. McMaster

The defining competition of the twenty-first century has been and will continue to be one between closed, authoritarian systems and free, open societies. Free and open societies appear to be at a disadvantage, because the United States, European countries, Japan, Australia, and others were, for much of the past two decades, absent from critical arenas of competition. That absence was due to what we might call strategic narcissism: the tendency since the end of the Cold War to define problems as we might like them to be and indulge in the conceit that others have no aspirations or agency of their own.

Strategic narcissism led some to believe that the arc of history had guaranteed the primacy of free and open societies over authoritarian and closed systems. Some also assumed that old features of geopolitics and international relations had become passé; global governance and a great-power condominium had displaced great-power competition. A corollary to those assumptions was that China, having been welcomed into the international order, would play by the rules and, as it prospered, would liberalize its economy and its form of governance.

Overcoming our self-referential view of the world requires an emphasis on what historian and Hoover Visiting Fellow Zachary Shore calls strategic empathy. Strategic empathy attends to the ideology, aspirations, and emotions that drive and constrain competitors. Empathy fosters a higher degree of competence because understanding the other exposes the unrealistic, often implicit assumptions that underpin policies, and it reveals dangerous cognitive traps such as optimism bias and confirmation bias.

Assumptions about the post–Cold War world turned out to be false. In this century, a new great-power competition has emerged. The actions of the Chinese Communist Party (CCP), actions driven by the party leaders' fears and ambitions, have revealed to the world that its Leninist system will prevent the Chinese people from realizing Milton Friedman's and John Taylor's vision of a free market that empowers individuals and drives prosperity by allowing people to make their own choices. As Friedman (2002) observed, "Underlying most arguments against the free market is a lack of belief in freedom itself."

The CCP is intensifying efforts to extend and tighten its exclusive grip on power internally and gain preponderant power in pursuit of "national rejuvenation" externally, through a campaign of cooption, coercion, and concealment. China coopts countries, international corporations, and elites through false promises of impending liberalization, through insincere pledges to work on global issues, and especially through the lure of short-term profits and access to the Chinese market, investments, and loans. Cooption includes debt traps set for corrupt or weak governments.

Cooption makes countries and corporations dependent and vulnerable to coercion. The CCP coerces others to ignore its efforts to extinguish human freedom internally, as it did in the case of the National Basketball Association and many US and international companies. And it applies coercive power to reshape the international order to favor its authoritarian, mercantilist model. Examples include the CCP's subversion of the World Health Organization, the Human Rights Council, UNESCO, and the International Civil Aviation Organization, to name a few.

While some industry groups and individuals still advocate for the accommodation of the CCP, it has become painfully clear that the free world must return to arenas of competition. To compete effectively, we must correct fundamental misunderstandings concerning the nature of the threat from the CCP and then discuss how the free world might prevail in competition and secure a better future for generations to come. *A common understanding of the nature of the threat could then generate the resolve to turn what authoritarian regimes regard as the weaknesses of free societies and free market economies into our greatest competitive advantages.*

* * *

The CCP uses two fundamental misunderstandings to justify various forms of aggression *internally,* as it perfects its Orwellian surveillance state, and *externally,* as it pursues primacy through programs such as Military-Civil Fusion, Made in China 2025, and One Belt One Road. As our colleague Elizabeth Economy has made clear, the CCP is pursuing a multipronged strategy composed of several high-profile initiatives that together aim to reshape global norms in accordance with China's state-led model. These include the Global Development Initiative, the Global Security Initiative, and the most ambitious of all, the Global Civilization Initiative to extend CCP influence over economic, security, and cultural governance worldwide.

The first misunderstanding is that Chinese aggression is the result of US-China tensions, a reaction to the Trump administration's description of China as a rival, or the imposition of very high tariffs. This misunderstanding derives from the narcissistic assumption that the party has no aspirations of its own and has no volition except in reaction to the United States. However, consider the party's deliberate suppression of the COVID-19 outbreak, the persecution of doctors, journalists, and others who tried to warn the world, and the subversion of the World Health Organization. Adding insult to injury, the party's "Wolf Warriors" obscured China's responsibility for foisting the pandemic on the world and portrayed its response and its authoritarian system as superior. Consider the massive global cyberattacks on medical research facilities in the midst of the pandemic and the punitive cyberattacks on and economic coercion of Australia for having the temerity to suggest an inquiry into the virus's origins.

In 2024, the US Department of Justice revealed that the China-linked cyber group Volt Typhoon had stealthily infiltrated US critical infrastructure networks for future espionage. Consider physical aggression on India's Himalayan frontier, in the South China Sea, in the Senkaku Islands, and especially toward Taiwan. Consider Xi Jinping's boasts of his intention to expand concentration camps in Xinjiang as he races to perfect an Orwellian surveillance state.

It should be clear to all that it was not the United States or even Donald Trump's constant refusal to be respectful of others that caused this behavior. So let all of us acknowledge that CCP aggression is not a US problem. It is a whole-world and especially a free-world problem.

It is essential that we correct this misunderstanding, since its corollary among nations in Europe and across the Indo-Pacific region is that the United States is asking them to choose between Washington and Beijing. And it is not a choice between Washington and Beijing; it is a choice between sovereignty and servitude.

The second misunderstanding is that competition with China is dangerous or even irresponsible, because of a Thucydides' trap that presents us with a binary choice between passivity and a destructive war. That is a false dilemma, and I would argue that passivity in connection with CCP aggression in the South China Sea and elsewhere has put us on a path to conflict. Had we remained complacent under the strategy of engagement and cooperation, China would likely have become even more aggressive. But the party promotes the false dilemma associated with Thucydides' trap to portray efforts to defend against its aggression as simply the status quo power, the United States, trying to keep the rising power, China, and its people down.

It is important to reject the notion of Thucydides' trap, because it provides cover for the party's aggression and a rationalization for those who are eager to shrink from competition in pursuit of short-term profits. International cooperation to defend against the party's aggression and cooperation is growing, but there is much more to be done. For example, the Quad (Quadrilateral Security Dialogue), which involves India, Japan, Australia, and the United States, is being reinvigorated.

But the Trump administration's tariffs on allies and occasional gratuitous insults are undermining cooperation. As I often said to President Trump in 2017–18, "If we shoot our allies to get to China, China wins."

Correcting these misunderstandings and improving cooperation with allies is important if we are to compete and turn what the CCP views as our weaknesses into our greatest competitive advantages.

* * *

Although the CCP views freedom of expression as a weakness to be suppressed at home and exploited abroad, our competitive advantage is what we regard as unalienable, universal rights: the free exchange of information and ideas.

People who direct academic exchanges or are responsible for Chinese students' experiences should ensure that these students enjoy the same freedom of thought and expression as other students. That means adopting a zero-tolerance attitude for CCP agents who monitor and intimidate students. When universities and other hosting bodies protect the freedoms that these students should enjoy, it serves to counter the propaganda and censorship to which the students are subjected in their home country.

Freedom of expression and freedom of the press also play a key role in promoting good governance to inoculate countries from bad deals under One Belt One Road. Exposing the CCP's cooption of corporate and governmental elites and its coercive practices that force companies and governments to act against the long-term interests of their shareholders and their citizens prevents the CCP from portraying its egregious acts as normal. Free and open societies must condemn the punishment of courageous Chinese journalists who expose the party's repression and persecution of its people. And companies should stop the practice of helping the party obscure its heinous repression of human freedom in Xinjiang, in Hong Kong, and across the country.

As with freedom of expression, the CCP views tolerance of diversity as a threat. Although some might see expanded immigration from an authoritarian state as a danger, the United States and other free and open societies should consider issuing *more* visas and providing paths to citizenship for *more* Chinese people, especially those who have been oppressed at home. Immigrants who have experienced an authoritarian system are often most committed to and appreciative of democratic principles, institutions, and processes. They also make tremendous contributions to our economies.

The CCP views its centralized, statist economic system as bestowing advantages, especially the ability to successfully coordinate efforts across government, business, academia, and the military. And it views decentralized, free-market economic systems as unable to compete with China's centrally directed strategies. That is why our free-market economies need to demonstrate the competitive advantages of decentralization and unconstrained entrepreneurialism.

Competition between the free world and authoritarian regimes will determine whether democracy and free-market economies prevail over authoritarianism and statist economic models. China and Russia have expanded their self-described "partnership with no limits" into an axis of aggressors that includes the dictatorships in North Korea and Iran, while they advance initiatives to displace US influence and power.

Winning this competition and addressing other cross-border challenges and threats, such as terrorism, climate change, and proliferation of weapons of mass destruction, requires a statecraft that draws on all sources of national power in an integrated manner. These sources of power include US military strength, its global diplomatic reach, the gravitational attraction of American ideals such as liberty and opportunity, and the US economy.

US administrations consistently undervalue the degree to which strategic application of economic power is essential for advancing US vital interests. President Trump has a historic opportunity to correct this chronic shortcoming in US grand strategy with an integrated strategy for economic statecraft oriented on securing the nation, reinforcing our technology innovation ecosystems, and shaping fair, reciprocal trade and commercial relationships.

Action is necessary to counter Chinese economic aggression, coercive or nonmarket actions by the CPP that bully allies or hurt American manufacturing. Action is also necessary to foster market conditions to ensure that the private sector meets critical national security needs in semiconductors, critical minerals, and other sectors.

The Trump administration must recognize, however, that these more interventionist economic statecraft policies will inevitably result in tradeoffs. An overarching framework of principles and objectives—a strategy—is therefore essential to help policymakers decide among competing trade-offs.

The private sector plays a vital role in countering Chinese economic aggression. Companies and academic institutions at the forefront of developing and applying new technologies must recognize that China is breaking the rules to take advantage of our open societies and free-market economies. A first step toward preserving competitive advantage is to crack down on Chinese theft of our technologies. The Trump administration should require companies to report investments by China-related entities, technology transfer requests from China, and participation in the CCP's core technology development or in its People's Liberation Army (PLA) modernization programs.

There is much room for improvement in the effort to prevent China from using the open nature of our economies not only to promote its state capitalist model and undermine confidence in our democracies but also to perfect its surveillance police state. Many universities, research labs, and companies in countries that value the rule of law and individual rights are witting or unwitting accomplices in the CCP's use of technology to repress its people and improve PLA capabilities.

Many companies are engaged in joint ventures or partnerships that help the CCP develop technologies suited for internal security, such as surveillance, artificial intelligence, and biogenetics. Others accede to Chinese investments that give the CCP access to such technology. Tougher screening for US, European, and Japanese capital markets is essential to restricting firms' complicity in helping the CCP's authoritarian agenda.

Finally, strengthening free-market economies and democratic governance could be the best means of countering the CCP's campaign of cooption, coercion, and concealment. Deregulation and permitting reform are crucial for competing with the People's Republic of China. Government and private-sector investment in technologies in the areas of artificial intelligence, robotics, augmented and virtual reality, and materials science will prove crucial for maintaining differential advantages over an increasingly capable and aggressive PLA.

Strengthening democratic institutions and processes in target nations may be the strongest remedy to China's aggression. After all, citizens want a say in how they are governed and want to protect their nation's sovereignty.

That is why support for free markets and democratic institutions, as well as the unalienable rights that should be afforded to all peoples, is not just an exercise in altruism.

Protection of these rights and promotion of democratic governance are practical means of competing effectively with the CCP while building a better world for future generations.

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15

Remarks on US Fiscal and Geoeconomic Risks

Matteo Maggiori

First, let me join in congratulating John Taylor on the conference held in his honor yesterday and for everything he has done for economics, both in academia and in policy. John's career is truly impressive, and I think we're all very lucky to have learned from him.

Turning to my remarks for today, let me start with the fiscal situation. Figure 15.1 is from the Congressional Budget Office (CBO), and it plots federal debt held by the public in the United States. It's no secret that the debt has been going up rapidly since before the Global Financial Crisis, as the United States spent heavily on the fiscal response to the financial crisis, and then again for the fiscal response to the pandemic. The last part of the line is a projection of what the CBO expects will happen going forward with the current legislation and planned spending. You can see that we're at the highest debt-to-GDP levels in the postwar period, and planning to increase the debt further and faster than the rate at which we grow. The last time we were at these debt levels, the debt was being used to finance World War II.

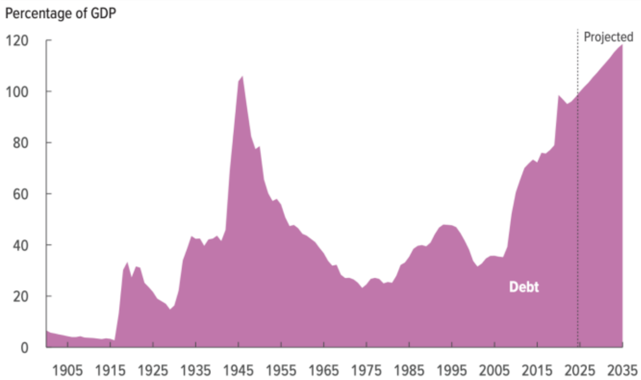

Figure 15.1. Federal debt held by the public, 1900–2035.
Source: Congressional Budget Office 2025.

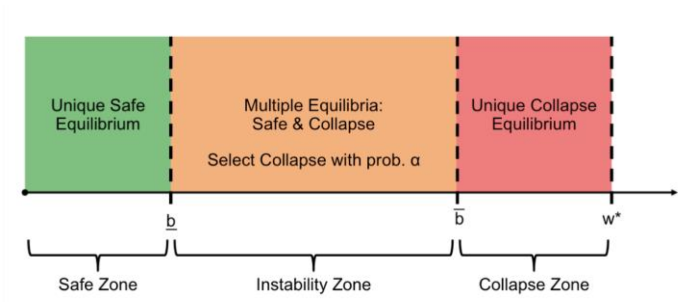

Figure 15.2. Thinking about the unthinkable: A run on the dollar and Treasuries?
Source: Farhi and Maggiori 2018.

Figure 15.2 illustrates the way I (and many economists) think about debt-to-GDP. The figure comes from joint work with the late Emmanuel Farhi (Farhi and Maggiori 2018). If there is very little debt over GDP, there is only a safe equilibrium. Everybody expects the debt to be safe. The borrower faces low interest rates, and given low debt stock and low interest rates, the borrower decides to repay the debt, fulfilling the expectations that the debt is safe. At the other extreme, there is a zone where the country has borrowed so much that it's pretty obvious it will default, and interest rates are high. Given high interest rates and high debt, indeed, the borrower defaults ex post. There is a unique "collapse" equilibrium.

But the intermediate region in the middle of the chart, also known as the instability zone, offers two possible outcomes:

1. Lenders get scared, for example, because the borrower mentions forceful extensions or threatens to stop paying interest. Interest rates spike, and at those high interest rates, since the debt is high and repayment is expensive, the borrower may decide not to repay, fulfilling the investors' expectations.

2. The other equilibrium, the good one, is still possible, however. If the lenders don't get scared, they will give the borrower low interest rates. Given those low interest rates, even with relatively high debt, the borrower can repay and fulfill investors' expectations.

If you once again consider figure 15.1, the big question that we all have right now is: Have we entered that middle region, the instability zone? Clearly, when the debt-to-GDP ratio was at 40%, I thought we were in the safety zone. But we don't really know where the boundaries between the regions are with any precision, since it is rather difficult to estimate them.

We wrote that paper about ten years ago, and many people thought we were a little crazy for considering the possibility of a run on the US debt market. You might still think there is a very low probability that the United States loses investors' confidence. But fast-forward to when we might have 150% debt-to-GDP ratios, and we'll have that conversation a lot more, and you'll start thinking the possibility is a lot less crazy. Ignoring the possibility that US debt might no longer be completely safe is a serious mistake. Once investors start thinking that since the United States has been safe for a while it will always be safe, that's generally when they get into trouble. It's exactly how we thought about the banks going into 2007. That turned out to be a major mistake.

When you look through the arc of history (some of my colleagues on the panel will do substantially better at this), there is nothing that should make you confident that because you've been a reserve country for long enough, you'll always be one. See figure 15.3: England had a stellar reputation and ended up going off the gold standard, which is largely a form of default on a promise that repayment offers a stable value. At the beginning of the Depression, it depreciated the pound unexpectedly and never really recovered its reputation.

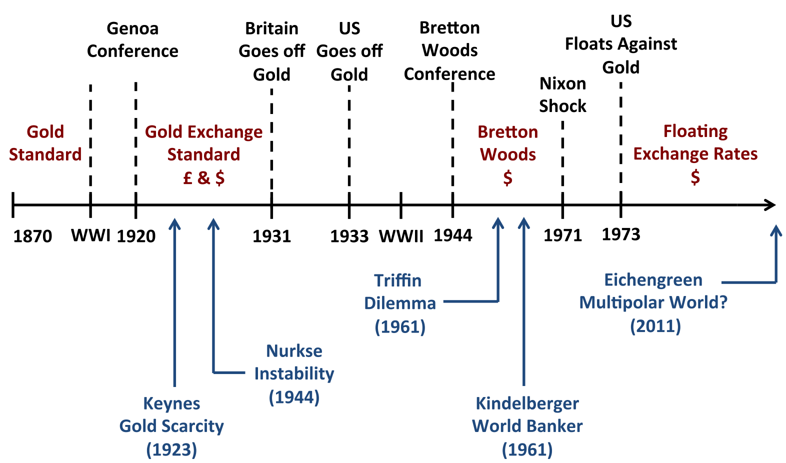

Figure 15.3. History warns against magical thinking: "Once safe, always safe."
Source: Farhi and Maggiori 2018.

Other reserve currencies in history have suffered the same fate. This doesn't have to happen, but your status is not guaranteed. You have it when investors are confident in your future fiscal and monetary policy and that the value of the debt (repayment) will be stable.

With this rather risky background on our fiscal situation, there has been a big surge in geoeconomic activity and uncertainty. You've all seen the headlines on tariffs, export controls, and proposed deals with China. The world order is clearly undergoing a moment of unprecedented change, one that certainly has not been experienced during my adult lifetime and for most of yours as well. That is worrisome, because if you're already in a position where you don't want bad multiple equilibrium outcomes, you don't want to induce more uncertainty and potentially trigger a change in investors' expectations.

What I've been doing in my research in the last few months (Clayton et al. 2025) is using artificial intelligence to read hundreds of thousands of documents in almost real time to try to figure out how firms are responding to sanctions, export controls, tariffs, and the related uncertainty. An overview of the results is shown in figure 15.4, plotting the share of global firm earnings calls that discuss the impact of export controls, financial sanctions, or tariffs on firm business or firm decisions. The findings are all online and available for you to download.

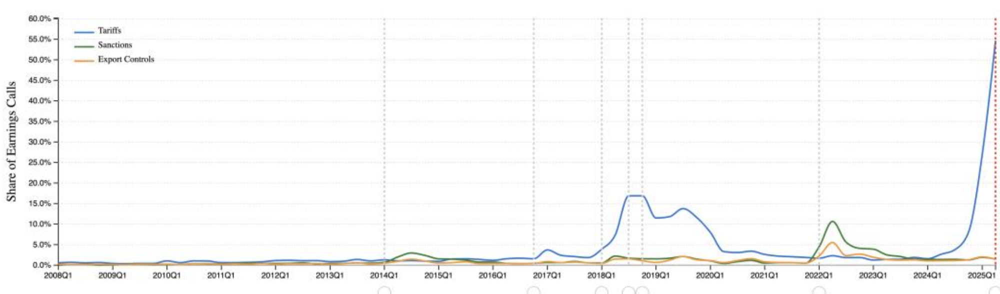

Figure 15.4. Geoeconomic pressure in earnings calls.
Source: Global Capital Allocation Project, http://globalcapitalallocation.com.

We observe three spikes in the reported impact of these tools around well-known episodes when geoeconomic pressure was applied or anticipated. The first is during the earlier Trump administration, reflecting the tariff wars with China in 2018–19. The firms massively report being affected by this. Then there is a spike in 2022, which corresponds to the sanctions on Russia. Finally, the tariff line goes vertical in the most recent period. This data is updated through April 24, 2025. Many firms are reporting being worried about tariffs or are already being affected.

How are firms talking about this? They might be talking about tariffs and saying they're a great idea, or they might be talking about tariffs and are worried about the negative impact. Figure 15.5 decomposes the line into positive and negative perceptions. Largely, firms are reporting that the tariffs are negatively impacting their economic outcomes. This happens even when we restrict the sample to only American firms.

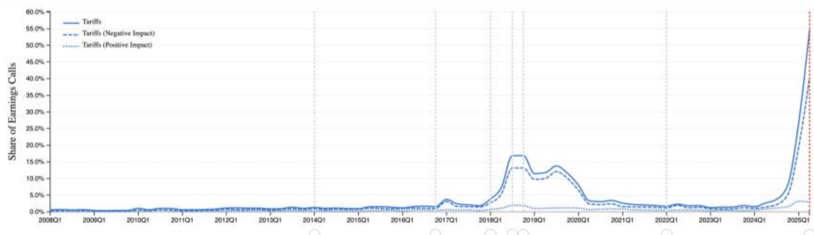

Figure 15.5. Positive versus negative impact of tariffs on firms.
Source: Global Capital Allocation Project, http://globalcapitalallocation.com.

At the very bottom right corner, you can see an increase in the share of firms reporting a positive impact of tariffs. Those are American firms that report their (foreign) competitors being more affected than they are, for example, in the steel industry. Those firms believe they will gain a bigger market share due to the tariffs. That belief illustrates how a tariff acts as a subsidy for domestic producers.

But overall, if you look at what firms and professional analysts are reporting, there is no doubt that the reaction to tariffs is negative. If you go one step further, you can then ask how exactly these firms are reacting to this new environment. This is what we show in figure 15.6.

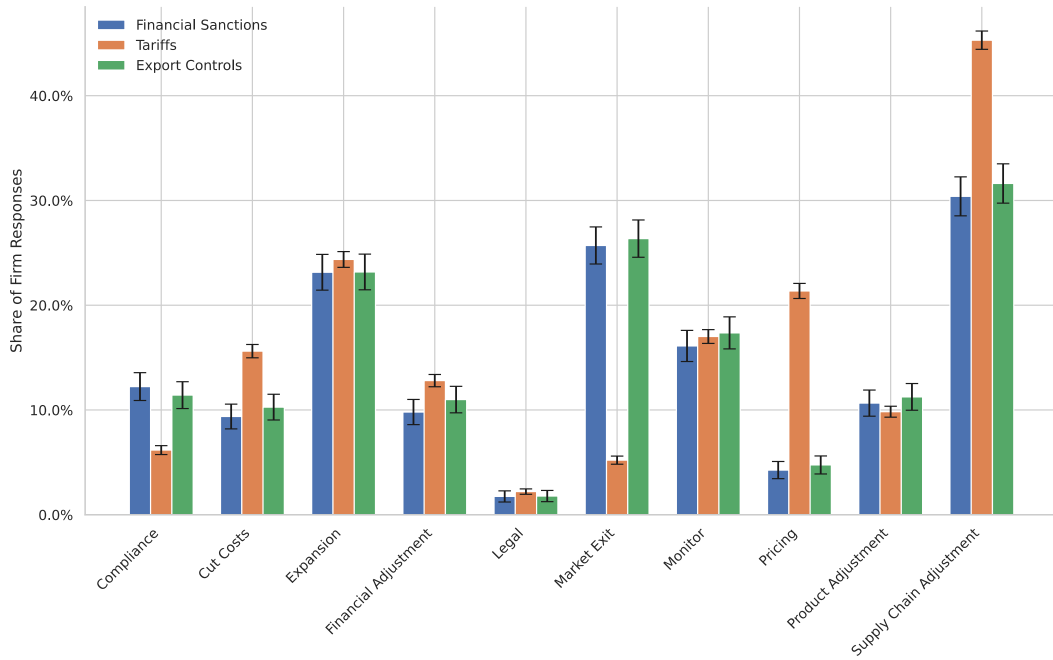

Figure 15.6. Firms' responses to geoeconomic pressure.
Source: Clayton et al. 2025.

First and foremost, firms are trying to get around these policies. They're trying to readjust supply chains to mitigate the effects of the policies.

When it comes to more targeted reactions, there is a significant difference in firms' responses to tariffs, sanctions, and export controls. When you look at the reactions to tariffs, they mostly mention adjusting prices. And I'll show you in a second that the prices are going up—they're reporting increasing prices. Tariffs are an ad valorem tax, a charge for doing a specific activity. Firms are passing through some of these taxes to the buyers of their products.

In contrast, sanctions and export controls are quantity restrictions. Either you cannot do an activity or you can do it up to a cap. In response to these policies, we find that the major reaction is market exit. You cannot export to China, you cannot export to Russia, or you cannot buy from Russia.

The major worry right now is prices. You might say, “Okay, you told me that firms are adjusting prices, but are they going up or down?” They’re going up, as shown in figure 15.7.

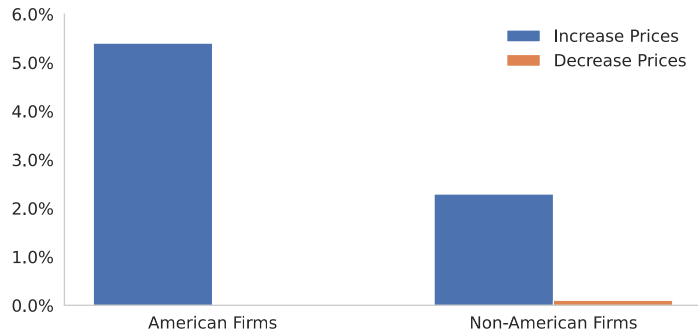

Figure 15.7. Firms report increasing prices.
Source: Clayton et al. 2025.

There is a major concern, as Fed Chairman Jay Powell articulated in early May 2025, that we may face a combination of weak demand and a supply shock simultaneously (Powell 2025). If you’re a sitting central banker, that’s not a great combination to have to fight. It’s more like walking a tightrope.

One of the great things about being at Stanford is that the university has made large investments in artificial intelligence. We’re going to keep doing these analyses in real time and at scale. The analyses I showed you, especially for the recent quarters, are still provisional as more data becomes available in real time. If you’re interested in this type of data and economic policy, you can find it online on our lab website (Globalcapitalallocation.com) and in the full working paper that I have summarized in my remarks (Clayton et al. 2025).

The policy message is that when you look at the data, both for the lead-up in March 2025 and the more recent results in April 2025, you see massive uncertainty. The firms are largely reporting negative outcomes. The positive outcomes are coming from the few firms that think they're going to get a bigger market share or higher profit margins because their competitors are more affected by the tariffs than they will be. The biggest responses seem to be increasing prices and moving supply chains.

I'm not sure that that's what the policymakers wanted, but if that was the plan, this did the trick. If the plan was something else, then we must confront the fact that these are the outcomes so far and see if we can improve the policies to get to the outcomes that we would have liked.

I certainly hope that policymakers will take these risks seriously and address them soon. A large debtor country like the United States inducing global volatility while not keeping its fiscal situation in order is not a good combination.

Thank you very much.

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Tariffs, Trade Wars, and Economic Policy as if History Matters

Christopher M. Meissner

The second wave of globalization, a period of intensified international trade, cross-border capital flows, and transnational migration that began around 1950, may not be over yet. However, the process of globalization is ostensibly at a crossroads.

The recent period of globalization, "Globalization 2.0," was founded on a strong belief in economic integration as a handmaiden of economic growth, development, and geopolitical stability. Hegemonic leadership by the United States and its allies provided the cornerstone of globalization. Throughout this period, the United States has generally advocated trade liberalization, reinforcing multilateral institutions like the World Trade Organization (WTO), the World Bank, and the International Monetary Fund, providing a market for the world's exports by running ever-larger trade deficits and issuing the globally dominant currency.

Since January 2025, the United States has abruptly changed the terms. The United States has started a global trade war by raising tariffs against nearly all of its trade partners, has clamped down on immigration, has mooted the possibility of taxing foreign investments in the US, and has emphasized the burden of operating the world's dominant currency.

These strategic changes have implications for economic growth and stability, as well as economic policy. They have their roots in the long run of history. In addition, the history of the global economy provides some guideposts for what may be in store in the future.

How did we reach this crossroads? The Global Financial Crisis of 2007–8 certainly played a role. This massive shock focused public opinion on ideas antithetical to the established “neoliberal world order” (Gerstle 2022). These included a revival of capital controls to contain financial flows, a greater degree of regulation on financial institutions, a willingness to blame import competition for economic losses, and a focus on the burden of trade imbalances and financial imbalances.

The second factor was the rise of a new global superpower since the 1990s. Between 1978 and 2008, the People’s Republic of China frequently recorded double-digit growth in exports and GDP, turning this impoverished and populous nation into a manufacturing powerhouse with an increasing dominance in strategic manufacturing sectors.

Some attribute China’s rise to its unfair trade practices, including industrial policies that subsidize industry and appropriate foreign technology. Another longstanding bone of contention was the allegedly undervalued exchange rate of the renminbi and China’s persistent trade surplus. Politicians and some economists decried the loss of employment in the United States due to these policies. Some even advocated trade sanctions on China as retaliation for exchange rate manipulation and continued violation of nonmarket allocation of resources and industrial policy.

The first significant action against China occurred during the first Trump administration, when tariffs on China were raised to 10% in 2018 with exemptions for certain products. These tariffs rose to 25% in 2019, and they continued through the Biden administration. In the second Trump administration, tariffs against China have at times gone to prohibitive levels, up to 145% or more on many products. Not only that, but the United States has raised some tariffs to 25% on close trade partners such as Canada and Mexico, with exemptions for products that comply with the United States–Mexico-Canada Agreement. There is a threat that by July 2025, tariffs could be higher on all trade partners in proportion to the bilateral trade deficit the United States has with these partners.

The recent rise in tariffs marks a watershed change in American trade policy. President Donald Trump has justified them by noting that "[President William McKinley] made our country very rich through tariffs and through talent" and that "we were at our richest from 1870 to 1913. That's when we were a tariff country" (Khalid 2025; Weissert 2025). The historical record is at odds with these statements. GDP per capita was about $6,300 in 1892 (in 2017 real US dollars) with an average tariff rate of 30%. But in 2024, US GDP per capita was $68,501 with an average tariff rate of 2.3%. In addition, Klein and Meissner (2025) show that between 1870 and 1909, industries with higher tariffs had lower labor productivity.

The broader American economic history literature argues tariffs have had, at most, modest effects on the US economy. Productivity growth in the United States in the nineteenth century was not driven by tariffs. Instead, the following forces mattered much more: intensive innovative activity incentivized by an efficient regime of intellectual property rights protection; relatively inexpensive raw materials and energy, owing to the discovery of abundant natural resources; the application of basic science to the use of such raw materials for product and process innovation; industrial agglomerations promoting idea sharing and other benefits of co-location; rising market integration with the build-out of the national railway network and roads; and strong immigration, which sustained economic growth in boom periods.

The period 1870 to 1913 coincides with the first wave of globalization. In this period, economies that had improved their access to global markets by lowering tariffs, improving infrastructure, and reducing overall trade barriers had significantly higher average incomes (Liu and Meissner 2013). Moreover, as global integration rose, international cooperation improved. Huberman and Meissner (2010) show that greater trade integration with leading countries gave those economies the leverage to persuade trade partners to improve their labor standards to match their own. The carrot of continued market access and the implicit threat to reduce access with trade sanctions were virtually always enough for trade partners.

Globalization collapsed in the interwar period (1919–38). The global trade war of the 1930s led to severe economic losses, illustrating the potential for economic dislocation and harm in a globalized trade dispute. The trade war of the 1930s was largely initiated by the Smoot–Hawley Tariff Act of 1930. Smoot–Hawley aimed to resuscitate the American primary sector after years of declining prices. Following lengthy negotiations in 1929 and early 1930, the bill grew to include higher tariffs for nearly all industries, leading to an average rise of 50% in American tariffs. Global deflation further raised the average tariff rate, as many tariffs were written in specific dollar-per-unit terms. Trade partners protested and retaliated with higher tariffs themselves. US exports fell by an average of 18% against "protestors" and 31% against "retaliators" (Mitchener et al. 2022).

Additionally, tariffs played a role in creating economic chaos and collapse in the early 1930s. Great Britain joined other Commonwealth economies in 1932, after the Imperial Economic Conference in Ottawa, to form an exclusionary and discriminatory trade bloc. Overall tariffs in Britain rose fourfold from about 6% to 24% between 1929 and 1935. Germany erected trade barriers and exchange controls after 1931 and attempted to engage in exclusive bilateral barter arrangements with a small group of trade partners. Average tariffs in Germany skyrocketed from 5% in 1929 to 30% in 1935.

The epic trade war of the early 1930s debilitated the global economy. Real exports in a representative set of twenty-eight economies declined by an average of 17%. For the same set of economies, the average decline in real income after three years from the pre-Depression peak was 23%. Using a trade multiplier approach, Albers and Meissner (2025) estimate that the trade collapse explains, on average, 63% of the decline in GDP. In other words, trade wars represent a significant negative shock to global incomes.

Based on these events, a continued reliance on tariffs in the United States, along with strong retaliation, could again lead to major economic damage today. The impact on incomes would be more significant for small economies and could be comparable to the downturn of the Global Financial Crisis.

The political consequences are also alarming. López-Córdova and Meissner (2008) argues that falling trade was associated with a retreat of democracy and a rise in fascism in the 1930s. It is hard to imagine that the collapse of global trade did not play a role in heightening the likelihood of international conflict in the late 1930s.

The period after World War II encompassed the second wave of globalization, or Globalization 2.0. In this period, America led a global drive to negotiate trade barriers downward. The various rounds of the General Agreement on Tariffs and Trade (GATT) pushed tariffs down to historically low levels. By the time the WTO launched in 1995, the principles of nondiscrimination and reciprocity had brought tariffs down to low single-digit levels among the advanced economies.

The reduction in tariffs brought significant economic gains. As in the nineteenth century, economies with lower trade barriers and better market access are richer (Jacks and Novy 2018). Such economies have better access to low-cost industrial inputs (Feng et al. 2016), a greater variety of consumer goods, a lower cost of living (Broda and Weinstein 2006), and enhanced employment and incomes, especially in sectors where these economies have a comparative advantage. Feenstra and Sasahara (2018) estimate that the growth of US exports between 1995 and 2011 generated 6.6 million new jobs in the United States, including 2 million in manufacturing and 4.1 million in services. The growth of US manufacturing imports from China reduced US manufacturing jobs by 1.4 million. Overall growth in employment due to the rise in exports and imports was positive, with net gains in the service sector. As a bonus, the second wave of globalization was associated with a renewed rise of democracy (Tabellini and Magistretti 2025). International integration and democracy during Globalization 2.0 created a pax Americana, or liberal peace, where territorial integrity was largely maintained.

Things changed considerably in the first one hundred days after Donald Trump's inauguration in January 2025. Since then, President Trump has advocated higher tariffs and has indeed begun implementing them. By early May 2025, the average US tariff was estimated to be about 23.3% (Trade War Tracker 2025). This is a tenfold increase over the prevailing average tariff of 2.4% at the end of 2024 and a historically unprecedented rise in US tariffs. At these levels, the average tariff in the United States is higher than it was in 1933, at the height of the trade war of the Great Depression. There is also a clampdown on immigration, which is having a chilling effect on foreign visits to the United States for work, leisure, and study. Members of the administration openly discuss whether the dollar's role on the international scene is leading to an unnecessarily strong currency and excessive investment in the United States that harms US exports and manufacturing capacity (Miran 2024).

What impact will recent changes to US trade policy have? Given the historical record and basic economic theory, I now make some conjectures about the likely impact on the US and global economy. In the short run, the trade war is likely to be purely a form of economic self-harm. The US economy will almost immediately see higher prices of imported goods, lower terms of trade, consumer and producer input shortages, and potential quality declines in tradable goods. The overall effect will be to lower employment and real income.

There is also the issue of uncertainty. Recent trade policy announcements have not been implemented following the usual deliberative process. The heightened uncertainty will almost certainly lead to significantly lower investment and consumption. An easing of monetary policy by the Federal Reserve could mitigate the negative employment effects of this shock. However, this would come at the cost of higher inflation.

In the medium run, there is likely to be substantial retaliation to higher US tariffs. Retaliation could take the form of higher tariffs on US-manufactured and primary exports, taxes levied by foreign governments on services provided abroad by American companies, and nontariff barriers, especially on US services exports and export embargos of rare-earth or other strategic products. Through 2026, this would lead to a continued decline in the terms of trade, lower employment growth as foreign demand dries up, and continued uncertainty and declining investment. An economy that is more "closed" is also a more volatile economy, creating additional strain for risk-averse households.

It is possible that the nontradable sector suffers relatively less from a global trade war. Employment gains in protected sectors seem unlikely given the uncertainty about the permanence of tariffs and the high fixed costs of rebooting industries that have been in decline for decades. Automation of any reshored tasks in manufacturing in protected industries is also likely to limit job gains. America continues to have a comparative advantage in high-skill and labor-intensive service industries. Further easing by the Federal Reserve could mitigate the losses from economic retaliation.

In a rosier scenario—call it "Globalization 2.1"—the threat of high US tariffs could potentially force reductions in foreign tariffs and nontariff barriers. US tariffs could also eventually come down as a result. Because it has been singled out, China may adopt a face-saving posture and refuse to negotiate with the United States. The best that the United States could hope for would be that Canada, Mexico, the European Union, and other strategic partners, like Japan and South Korea, keep their trade barriers low.

A situation of near autarky with respect to China-US trade, but business as usual with the rest of the world, would cover about 85% of US trade in goods and services, using 2022 pre–trade war trade shares.[1] A drop in barriers to trade by America's main trade partners, excluding China, could boost GDP by several percentage points, a significant increase for US aggregate demand. If China were to increase domestic consumption and lower its saving rate, which would reduce China's trade surplus, and if it were to lower its tariffs and nontariff barriers, there would be a further benefit to the US economy. Facing lower trade barriers abroad, the United States could intensify its lead in services exports, including artificial intelligence, information technology, cloud computing, data, finance, and insurance. The primary sector could see meaningful gains, too. An economic expansion on the back of an import and export boom could occur. Globalization 2.1 would see greater integration, higher growth, and lower inflation, with services exports expanding rapidly and imports of tangible goods also increasing. Monetary policy could remain neutral or even ease as the trade shock acted as a positive impulse to aggregate supply. The world would be richer and safer in this case, which is a scenario worth hoping for at the very least.

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[1] In 2022, US exports of goods totaled $2.1 trillion. US exports of services totaled $926 billion. US imports of goods equaled $3.2 trillion, and US imports of services totaled $680 billion. China purchased 7.5% of US exports, and the US bought 16.5% of its imports from China. Data from the US Trade Representative website, downloaded on May 6, 2025, https://ustr.gov/countries-regions.

17

Geopolitics and Economic and Monetary Uncertainty

Harold James

Today, everyone talks about geopolitics. The idea is infectious. It appears to come from nowhere. Twenty years ago, the term was exotic, and the meaning behind it quaint. The world was different then. In 2002, *America Unrivaled*—a book edited by my Princeton colleague, G. John Ikenberry (2003), the foremost exponent of the idea of liberal internationalism—asked why there was so little resistance from other countries to American power projection. That was when the momentum in the United States for an attack on Iraq was building up. The book's contributors argued that there was no balancing against the unipolar moment created by the disintegration of the Soviet Union; in short, no geopolitics. That has changed in the course of this century, and the word "geopolitics" began its road to dominance of political discourse. We are now thinking of its impact on the economy and on monetary policy.

Geopolitics is a classically ambiguous or nebulous term, with an innocent and a dangerous use (see James 2022). For some, it is a vague sense of continents and big geographical spaces, or just that geography matters in the sense that the United Kingdom is more likely to trade with France and Ireland than with New Zealand. For others, it is about a claim that reality consists of endless conflict and struggle, in which space matters more than ideas, maps more than chaps. This is a bleak, conflictual, zero-sum world. The term "geopolitics" as used in the conflictual sense is also fundamentally a recognition that globalization has failed. It is not surprising that it emerged as a particular usage in countries that felt they had lost out in a global competition, such as Germany after the First World War, where the geographer Karl Haushofer introduced Adolf Hitler to the concept, or Russia after the breakup of the Soviet Union. In the 1990s, Aleksandr Dugin explicitly channeled Haushofer's thought, and it had an impact on Vladimir Putin, whose political strategy was based on correcting what he considered the greatest geopolitical catastrophe of the twentieth century: the end of the Soviet empire.

Space and place clearly do matter. At times, the world's attention focuses on particular geographic hotspots: some dominate the geopolitical imagination, such as the eastern Mediterranean and the Dardanelles; the passage between the Black Sea and the Mediterranean Sea assumes global significance, being a thin needle that connects the grain-producing areas of autocratically controlled central Eurasia to starving consumers in the Middle East and also in Asia. The new conflictual reality is the product of multiple shocks—the 2008 Global Financial Crisis, the COVID-19 pandemic of 2020, and the Russian attack on Ukraine in 2022.

It is easy today to see parallels to previous eras of tension in the midst of a globalized world, perhaps especially to the years before the First World War and the debate that then gripped Britain about the relative loss of power and preeminence. An old debate, going back to the French philosopher Montesquieu's arguments in the eighteenth century about the pacifying power of *doux commerce*, was brought up in the pre-1914 world, when some analysts—notably Joseph Schumpeter—contrasted the benign logic of commercial relations and the atavistic feudal urges to militarism and imperialism. For Schumpeter, nationalism and militarism, which are "not creatures of capitalism, are 'capitalized' and end by sucking the best strength out of capitalism" (1919, 75). Schumpeter used as the star witness for his thesis the rhetoric of the great British imperialist politician Joseph Chamberlain, quoting Chamberlain's two key messages in English: "learn to think imperially" and "tariff reform means work for all." Chamberlain was obsessed with British decline, but his preferred remedy, tariffs, proved ineffective when ultimately implemented. And his son, Neville, who as chancellor of the exchequer implemented the tariff proposal, would go on to become prime minister and destroy the credibility of British foreign policy.

Why do some shocks foster globalization while others seem to reverse globalization? Some people describe the trajectory in terms of intellectual fashions—the victory of the free-trade economics of David Ricardo and John Stuart Mill in the mid-nineteenth century or of the so-called neoliberalism of Milton Friedman and Friedrich Hayek in the 1970s. But the question about the influence of theoreticians only leads to another question: Why is policy open to particular influences at certain moments?

The more plausible explanation for thinking about the aftereffects of trauma lies in the character of the shock. Not all crises are the same. In particular, we should distinguish between supply and demand shocks. Economists distinguish the influences on key indicators—output and prices—by differentiating between influences that affect aggregate supply and factors that shape demand.

A supply shock changes the ability of producers to make goods that add to overall output, and directly affects prices, quantities of input, or production technology. A negative shock reduces inputs and increases prices. A positive shock would increase inputs and lower prices. The supply shocks thus move the equilibrium price level and the equilibrium output in opposite directions.

By contrast, a demand shock affects spending by buyers, whether individuals, businesses, or governments. It might be expected to affect output and production. A positive shock leads to more economic activity, while a negative one diminishes activity. But in this case, equilibrium prices and output move in the same direction: up when the demand shock is positive, and down when it is negative. Financial crises, when they emerge from a malfunctioning, ill-constructed, or badly regulated financial system, are simply negative demand shocks, destroying the ability of individuals and businesses to buy products while pushing down both prices and production. The course of globalization was interrupted by two serious, very negative demand crises, each brought about and amplified by financial turbulence: the Great Depression of 1929–33 and the Great Recession after the 2008 financial crisis.

To see how some crises stimulate further integration, it is helpful to go back to the beginning of the modern era of globalization. The surge of interconnectedness in the nineteenth century started as a response to a shock: the harvest failures, famines, and then financial and business collapses of the mid-1840s. Europe then experienced a continental wave of revolution in 1848. Karl Marx gave a powerful analysis of how global integration was driving the world and producing vulnerability and exposure. But the economic shock of the 1840s did not reverse the course of integration. Instead, prices rose, trade expanded, governments reduced tariff barriers, capital surged, and people moved across continents in response to the experience of misery but also to the promise of new prosperity.

In the 1970s, the oil shocks altered the policy paradigm. Initially, more protectionism emerged as a response to big trade deficits in industrial countries and as a remedy for exposure to global risk. The Cambridge Department of Applied Economics under Wynne Godley became a base for advocates of a siege economy. But instead of limiting trade, the policy community shifted toward deregulation, disinflation, and more openness, with center-left governments leading the way: Jimmy Carter in the United States, James Callaghan in the United Kingdom, and Helmut Schmidt in Germany. And they prepared the way for Ronald Reagan, Margaret Thatcher, and the much milder German version, Helmut Kohl.

Negative supply shocks may just be temporary, in which case we may expect a short surge in inflation, then a deflationary interlude, and a relative return to normalcy or the pre-shock pattern of price behavior. They may be persistent, with expectations that the price of the scarce good will be permanently high; modeling of that scenario suggests that the long-term effect, after an initial spike, on underlying or core inflation would be a small augmentation. Finally, the shock may be the beginning of a long-term, continued upward movement in the price of the scarce good. In this case, the modeling would suggest that the core rates of inflation continue to rise (Blinder and Rudd 2013). All modeling efforts of this sort assume that there is a clearly discernible pattern. However, the big historical shocks that shifted the course of globalization were quite different. They were not normal or predictable events. They brought substantial dislocations. Their outcomes were uncertain. They caused profound political trauma.

In these circumstances, the responses by intelligent people trying hard to see what the future might hold actually transformed the structure of production and distribution. The radical character of the shock spurred a search for alternatives, including new products but also new mechanisms to move goods. In the two major episodes covered in these pages—the 1840s and the 1970s—supply problems prompted a transportation revolution. It was not that the transformative technologies, the railroad and the container ship, were completely novel. The uncertainty and the political disruption pushed or eliminated barriers to a much wider implementation that would transform the supply problem by radically reducing transport costs.

The character of the shocks impacts the way they change attitudes about integration or globalization. Modern globalization began in response to a very abrupt negative supply shock, in particular, the response to the traditional problem of premodern economies, which included harvest failures and crop diseases leading to mass hunger. Food prices, along with those of other necessities, shot up, and consumption fell back. The negative shocks also radically transform distribution networks: Small intermediaries are eliminated, often with a substantial initial cost to the general well-being. In many crises of this kind, it is the same sort of suppliers who are vulnerable: shopkeepers in the famines of the 1840s or the First World War; small shops and restaurants during the 2020 pandemic. They are often blamed for the problem, and at the same time, their business model collapses and they fail.

The negative supply shocks of the mid-nineteenth century and then in the 1970s produced the most obvious globalization surges, as measured by the metric of the relationship between international trade and production (see figure 17.1).

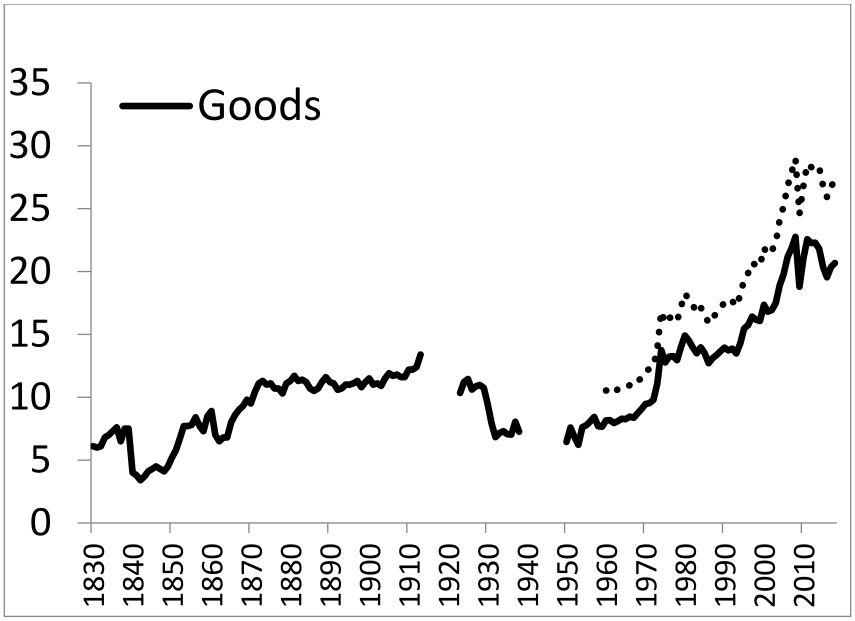

Figure 17.1. World exports as share of world GDP 1830–2018.
Source: Data from Catão and Obstfeld 2019.

Today's world and the intensification of geopolitical debate have been fundamentally shaped by the aftermath of the Global Financial Crisis, aka the Great Recession of 2007–8, a classic demand shock induced by a financial meltdown, but also more recently by the COVID-19 pandemic, which started in the winter of 2019–20. The responses to COVID-19 immediately induced a supply shock as they shut down transportation and stranded ships in the wrong place. What was not sufficiently understood at the time was that supply shocks propagate themselves for substantial periods because they play into a zero-sum mentality. Each country that controls a particular scarce commodity thinks that it can use its control to bend other countries to its will. The clearest example is how Russia in 2022 was emboldened by the energy (gas and oil) hold it had over the European Union to assume that a quick surgical strike to destroy Ukraine would go unpunished and that the outcome would be rapidly accepted. Other countries also used their control of energy: Algeria, for instance, locked in a territorial conflict with Morocco over the Western Sahara, threatened to cut off gas supplies to Spain if Spain continued to send gas to Morocco.

In the wake of Russia's actions, many of the supply constraints were unexpected. Russia and Ukraine had been supplying 30% of the world's traded wheat, and prices surged, affecting other grains that might be considered substitutes. EU natural gas prices tripled from February 18 to March 7, 2022. The world's business community was astonished to learn that 90% of the neon gas used in the manufacture of semiconductor chips came from Ukraine, and that that neon was derived from waste products from Russian and Ukrainian steel mills. There were new shortages and price spikes for palladium, platinum, argon, and krypton. German automobile producers had their production temporarily halted because of the absence of the simple and low-tech wire harnesses made in Ukraine, and needed to reorganize wiring in their engines until an alternative supply could be arranged.

By 2023, with what looked like a new Cold War between China and the United States, attention shifted to rare earths and minerals in China, as well as in many African and South Asian countries under substantial Chinese financial influence. But which of these critical minerals would be really critical? It was difficult to tell in advance. The 2023–24 European Bank for Reconstruction and Development Transition Report devoted its attention to how Chinese materials would be essential for the "green transition" worldwide. A large table in the report included sixty-three possible critical minerals, including dysprosium (EBRD 2023). The text did not discuss its significance. Then, as attention shifted toward rapid advances in AI and nuclear fusion, dysprosium acquired new importance. Its magnetic qualities made it a central component in the control of nuclear processes and also for large-scale computing centers. Export controls were imposed as a countermeasure to the Trump administration's increased tariffs on "Liberation Day," April 2, 2025.

The long-drawn-out supply shock thus has parallels with earlier episodes in the 1840s and the 1970s. It is worth drawing out the similarities:

1. Each led to an inflation surge, as monetary policy responded to pressures to provide more liquidity. The surges were not temporary, as many observers (a group colloquially termed "Team Transitory') in 2021 dogmatically asserted. But there is also no reason to believe that they should lead to permanently higher inflation models. Such inflation surges are not transitory but are a feature of a profound economic transition.

2. Each led to a substantially increased pace of technical transformation, which was the basis for the transition and was driven by the price signals sent out by scarcity, by the negative supply shock. In the mid-nineteenth century, the use of the steam engine in railroads and transoceanic steamships led to improved networks of communication. In the 1970s, transportation techniques (the container ship) again stood at the center. In today's world, the equivalent transition is the fast adoption of AI.

3. Each also led to increased geopolitical tension as states struggled for access to resources. The break of the mid-nineteenth century was followed by the most significant interstate war in the years between the Napoleonic conflicts and the First World War: the Crimean War, fought over the Russian Empire's access to the Black Sea and the Mediterranean. The 1970s produced war in the Middle East (the Yom Kippur War) and the Iranian Revolution.

The 2025 Trump tariff surge has produced a new element of shock. It constitutes, above all, a supply shock, with increased costs for the US economy and a demand shock for the rest of the world as sales to the United States drop off. It is easier to see how the rest of the world will adapt, with big new fiscal stimuli grounded on differing logics in Europe and in China, than how the United States can improve its situation (and reduce the inflationary impact on consumers). Unless there is a complete policy retreat.

The supply shocks affect consumers in the United States, and they will focus on ordinary products that become more expensive, scarce, or even unavailable. The impact on high technology will be even greater and more devastating, especially in supercomputing and AI, but also in the key technology of nuclear fusion. Cuts in research funding will also reduce the capacity for long-term scientific innovation. If that course is maintained, people will treat the twenty-first-century American story as a parallel to the long declines of imperial Spain or twentieth-century Britain.

The good news for everyone else is that globalization will still work for most countries, and that new drivers of globalization will emerge—in big emerging-market countries but also elsewhere, in Latin America, Eastern Europe, and Africa. Even Ukraine may develop as a result of its martyrdom as a leader in military technology, notably in the rapidly changing area of drone warfare.

It may be that the United States will come to a realization that the tariff regime is like shooting oneself in the foot, or rather in the head (because it is stupid) and the heart (because it is cruel, especially to smaller African and Asian economies, such as Vietnam and Lesotho). It may even be that the tariff pause is the beginning of such a reorientation. For most other countries, a new technology-driven globalization holds many opportunities and chances.

The monetary consequences of escalating global conflict include increased concern about the US dollar's internationally dominant position. As the twenty-first century has unfolded, suspicions and hostilities have mounted, and central bank purchases of gold have surged at moments of geopolitical tension: after 2011, and then much more dramatically after 2020 (see figure 17.2). The new emerging economies have seen a way to free themselves from the US dollar by buying gold. China, India, Kazakhstan, Türkiye, and Russia have become major purchasers. Often, the motivation has been a response to the increased use of sanctions as a diplomatic weapon. The threat of financial sanctions, including asset freezes or confiscation, for instance, drove Belarus after US and EU sanctions in 2006 or Türkiye after US and EU sanctions in 2018–19 to build up gold reserves (Arslanalp et al. 2013). But Europeans also joined in that gold surge. In 2013, the Bundesbank announced a plan to bring half of Germany's gold reserves back to Frankfurt by 2020, resulting in around 300 tons of gold being shipped from New York and 374 tons from Paris. (Deutsche Bundesbank 2017). In 2015, China dramatically announced that it had increased its gold reserves since 2009 by 60%, to 1,658 tons. Russia began large-scale purchases and, in 2018, almost caught up with China in terms of gold holdings. Its central bank was buying gold from banks that financed expanded Russian gold production (GCRU Gold News 2018). President Putin explained that de-dollarization was a response to US sanctions over Crimea (Kantchev 2018). In 2022, in the aftermath of Russia's full-scale attack on Ukraine, around $300 billion of Russian central bank assets were frozen by the West, with most (substantively over $200 billion) held in Europe, and mostly in the form of government bonds, the profits from which were used to guarantee loans to Ukraine. The G7 engaged in a contentious debate on the merits (and the legality) of confiscating these assets.

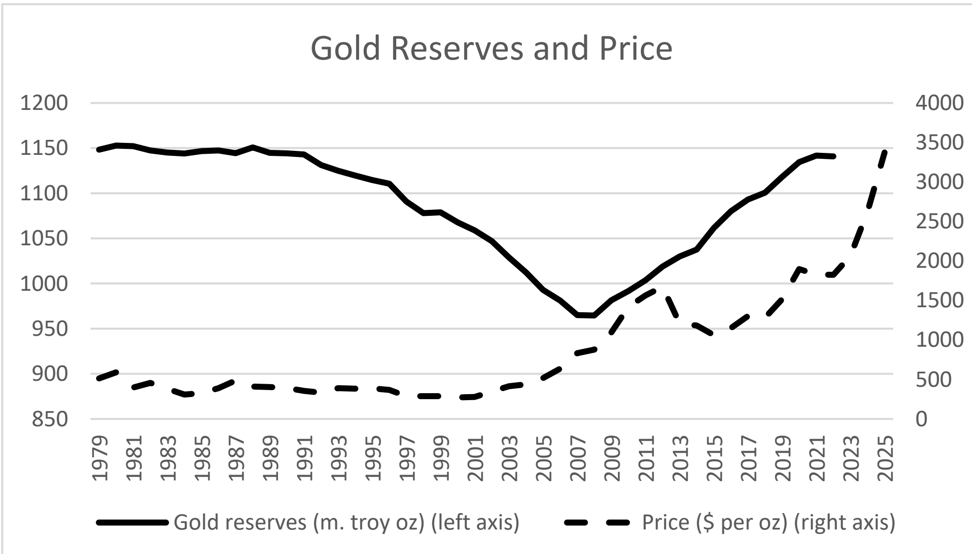

Figure 17.2. Gold price and gold reserves 1960–2022.
Source: Data from International Monetary Fund International Financial Statistics and goldprice.org.

The dramatic rise in the gold price since the Global Financial Crisis of 2007–8 reflects at least two considerations. First, gold looked more attractive in a low- or negative-interest-rate environment, since the cost of holding gold and forgoing interest on reserves declined. A similar consideration applies to new assets such as Bitcoin, which was explicitly designed to replicate the scarcity generated by the cost of physically mining gold. And secondly, the security calculations on the need for a strategic reserve were analogous to those of the nineteenth century, as was the logic of countries responding to the gold policy of other countries.

Worried, Central European countries followed the lead from China and Russia as they saw their security becoming more fragile. When the Czech Republic joined NATO in March 1999, it immediately sold all its gold reserve. The linkage was very clear: Gold was an emergency reserve, but membership in a security alliance offered a much cheaper way of getting the same assurance. From 2018, the signs were reversed, and gold was great again.

Gold became the most obvious symbol of the new world of zero-sum thinking: You need to have it and to deprive your neighbors of it. It is a security instrument, not a tool of cooperation. As cooperation erodes, those who feel vulnerable and believe they are losing will think more and more about geopolitics. A remarkable feature of President Donald Trump's rhetoric is the way in which he has focused on how the United States is a loser in globalization. Losing and thinking about geopolitics become part of a self-perpetuating spiral, as they did in interwar Germany or post-Soviet Russia.

These developments have immediate consequences for the appropriate design of monetary policy. The combination of the effects negative supply shocks have on prices (higher prices and continuing expectations of higher prices) and on demand (falling demand and enhanced fears of recession) creates stagflationary circumstances, as in the 1970s, which make any application of any rules-based monetary policy (notably in Taylor rule variants) harder to apply. Monetary policy then becomes a prisoner of the spiral of noncooperative perceptions, as it is challenged by the requirement of responding to the price signals generated by geopolitically induced supply shocks.

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General Discussion

Sebastián Edwards: Great panel.

Harold James ended with gold. Its current price is $3,300 an ounce. That's a lot of money. Go back to Matteo Maggiori's interesting timeline. He talked about reputation and credibility. He pointed out that in 1931, the United Kingdom devalued sterling by 30% or so and never recovered.

In 1933, the United States not only abandoned the gold standard but also abrogated the gold clauses, which allowed bondholders the option to be paid in gold. It literally defaulted on public debt and required a default on private debt. It devalued the dollar in January of 1934 by 41%. In 1935, the US Supreme Court said that it was constitutional to abrogate gold contracts retroactively. But in the US, credibility actually increased. We had a new equilibrium. As Barry Eichengreen, Chris Meissner, and others have documented, gold came back to the United States, deflation stopped, and we got out of the Great Depression.

So the question is: is there an alternative to the doom scenario? I am personally pessimistic, but if we look back at history, there is an outcome already in history where the United States defaults and maintains its privileges.

What are the probabilities of the good or bad outcome being the final outcome? Chris had an optimistic outcome, but he didn't give us probabilities. And I think that looking back at history, the abrogation of the gold clause is a very, very important episode.

Steven J. Davis: Thanks for a great panel. There's an important aspect of the present moment that I thought was missed in the discussion. I want to draw the contrast between the current tariff hikes and the Smoot–Hawley Tariff Act.

Smoot–Hawley was a piece of legislation that was passed by Congress. The tariff hikes and gyrations in the last three months are entirely the whim of one man. And most of these tariff hikes rest on dubious appeals to lawful authority—for example, to legislation that never mentions tariffs or to legislation that appeals to emergencies.

In contrast, the kinds of things President Donald Trump is concerned about are long-run trends. The way that the Trump administration's trade policy has been rolled out reveals something important about the present moment that affects the outlook for uncertainty and for further globalization. In particular, we are seeing tariffs and other policy actions that seemingly involve an unrestrained exercise of executive authority without clear grounding in the law or even the Constitution.

These matters are being litigated now. They will eventually reach the Supreme Court, and perhaps the Court will reimpose some constraints. Perhaps under some circumstances, one can imagine that Congress might take back its power to set tariffs. But until there's some kind of reimposition of constraints on the executive's authority to raise or lower tariffs at the president's whim, I don't see how we return to a stable, reliable trading system of the sort we have experienced in recent decades.

We can have trade deals, but they don't mean much because they're not credible. So in that respect, I see this current moment as quite different from, say, the Smoot–Hawley tariffs. And it speaks to me of the need for internal US reforms to restore, domestically and internationally, a situation where the United States is the linchpin of a global economic commons.

Ross Levine: Let us turn back to our panelists. Sebastián's question is, is there room now for the United States to abandon some obligations? What would the ramifications be? Would it be catastrophic, or might it be different?

Steve Davis asks whether this time is different, that some of the historical analogies don't hold because what's going on today is an assertion of executive authority.

Matteo Maggiori: To Sebastián's question. Sebastián has a wonderful book on the US abandonment of the gold standard. I would say that something similar happened in 1973. President Richard Nixon went off the Bretton Woods system, and money flowed to Switzerland. Switzerland went to negative interest rates and capital controls. Eventually, investors came to their senses that Switzerland was too small, and there was no alternative. And US centrality survived. The question is, do you want to take that chance?

For the United Kingdom, the existence of an alternative, the United States, might have facilitated the permanent exclusion of the United Kingdom from the central role. So there is certainly a big sense that, as former Prime Minister Margaret Thatcher put it, "There is no alternative," plays into this question.

It's a very informal notion, particularly in economic analysis. But as China develops, as the European Union might get its act together in terms of capital markets integration, any signal that the US is not going to fulfill its obligations in the presence of an alternative can be very expensive. I certainly don't have a good guess of whether you could get away with it or not, but why on earth would you even try, rather than play the good equilibrium to Steve's question?

Steve has done amazing work with Nick Bloom on uncertainty in text, and I piggybacked on top of that in my remarks. I think you're totally right. A lot of what is happening is uncertain. It's uncertain not just because it changes very quickly, but also because even if it were to stick, it would have to go through a lot of litigation and presumably through Congress, which may assert more of its authority in the tariff space. That's where I think the text and the high-frequency data approaches make a huge difference. Firms have to react to events in real time. They don't have the benefit of waiting three years and figuring out whether Congress woke up and we didn't have the tariffs.

A lot of the effects that we're seeing are coming from pure uncertainty and volatility rather than anything that is currently on the books. On the books already, there are the steel tariffs, and tariffs from the first Trump administration, which the Biden administration didn't take down. So there are some tariffs already there. They've stuck around through two administrations. If I were a firm, I don't know whether I would expect that these things are going to be quickly reversed, given what we've seen in the last two administrations. That's also why I think looking at the actual tariffs that get implemented would miss most of the economic action. And the Uncertainty Index and things like that play a very big role in thinking about what people are actually reacting to.

Harold James: Two questions link together. First, Steve's question about the tariffs and the difference between Smoot–Hawley and the present is absolutely right. But I think in both cases, there was a sort of learning effect.

People quickly realized that Smoot–Hawley was the result of congressional action. Going through Congress increased what President Herbert Hoover had originally had as a modest agricultural tariff into a massive tariff book. The Roosevelt administration reacted with the Reciprocal Trade Agreements Act in 1934, which took the power back to the president. The president has an overall view of the United States rather than thinking about each little bit, and where some in Congress will benefit from some particular tariff. In terms of constitutional challenges, many people are making exactly the point that you're making that these tariffs are actually unconstitutional, and they demand to be challenged. So you can expect a shift back to Congress.

The link to Sebastián's question is the rather odd fact that Franklin Roosevelt, after he abrogated the gold clause, enjoyed fixing the exchange rate of the dollar in an arbitrary way. Famously, he liked to joke with Treasury Secretary Henry Morgenthau that he was fixing the rate of the dollar for the day by looking at the tea leaves that he poured out of his teapot.

So in the same way as this was a kind of arbitrary exercise, we came back then to the conclusion that we need a rules-based framework. And that brings us back to the world of 1944 and the Bretton Woods Conference and the world of rule-based monetary policy.

Christopher M. Meissner: I have a comment on what Steve said. I agree with Harold. Tariffs have seemingly become a tool of foreign policy as much as economic policy, which leads to new complications that we haven't seen before. It's not totally clear whether Congress wants to take back the powers that it originally had and has given many powers to the executive branch in various trade acts.

We'll have to monitor that situation and see how the courts decide. And I think our best chance is public opinion. We'll get immediate feedback in the months to come on the effects of tariffs. And my guess is that many people, as per Matteo's talk, will be hurt from these tariffs and that will swing public opinion.

But again, there's the foreign policy imperative, which ties back to the first talk on this panel, which is getting more interesting by the day.

Krishna Guha: I want to return to this question of an "instability zone" that Matteo referenced in his presentation.

It strikes me that while there are lots of contradictions within the administration's trade agenda at the moment, the dangerous contradiction is between the trade policy and its implications for capital flows, the fiscal situation, and the risks that are attendant to that. Of course, as the panelists have rightly said, tariffs do not just attempt to compress trade deficits themselves.

The issue is the wider retreat from international economic integration that tariffs represent, and potentially, security integration as well. So even in the baseline case, that's likely to reduce the convenience yield on holding risk-free, dollar-denominated securities. That's going to increase the interest that the US needs to pay on government debt.

It seems to also increase the likelihood that at some juncture we could reach a global buyer's strike, for instance, if the deficit were to explode in a cyclical downturn with a lot of discretionary fiscal stimulus to try to buy our way out. So beyond observing that we're in this terrain where you could have multiple equilibria, is there anything that we can say beyond that to bring some sort of discipline to thinking about how we might switch from one equilibrium to another? Is it pure sunspot stuff, or can we think about this from a more operational perspective?

Kana Norimoto: To build on Krishna's question with regard to capital flows, I'd like to invite the panelists to tell us what they think is the right policy solution for the potentially hyper-mobilized financial flows that we may see on the back of these policies. I think it's quite interesting that we've already had an appreciation of the Taiwan dollar last week.

It seems some of our Asian allies are thinking that perhaps they need to appreciate their currencies to placate our current administration. This could mobilize, through the foreign exchange channels, a significant unwinding of the investments that they have made in our markets. So I'm curious in particular if there are any lessons to be learned from the experience of the United Kingdom and the sterling area and how we would be able to solidify some of the capital that is held in US instruments by our allies abroad?

Michael J. Boskin: Chris, you had these beautiful graphs of the history of tariffs and how high tariffs did not lead to increased prosperity. But much of the discussion of tariffs that's going on now has a flip side that is kind of nutty, because for much of the history of tariffs, they were the major revenue source for the federal government. They were there to raise money to fund the government, not just to protect industries.

Of course, there was protection, but revenue was one of the main purposes, in any event. We didn't have an income tax. You couldn't have an income tax in the 1820s. Nowadays, obviously, we have many more tax devices.

We have, for better or for worse, debt. Tariffs, even the large ones we're talking about, if you make any reasonable calculations, would be a tiny fraction of federal revenue. So I just think that people who relate current events to the nineteenth century are missing half the story.

Levine: I would like to pose a question to H.R. McMaster, because I'm very interested in the strategic elements. Then I'd like to give everyone a chance to answer the questions they find most compelling.

H.R., how has the United States been doing over the last five years concerning creating national security in the long term?

Let's go in reverse order to how we started the panel.

James: I think revenue and tariffs are enormously important points. It also makes me think about what the reaction of other countries to the chaos might be. Other countries might say, "well, you know, you, the United States, is terribly worried, or at least Mr. Stephen Miran, chairman of the Council of Economic Advisors seems to be terribly worried, about the way in which the inflows of capital into the United States have created an extraordinary exorbitant liability rather than an exorbitant privilege. So we're going to help you. We're going to put a tax on revenue that comes from investments in the United States." It seems to me that this would be plausible and attractive from the revenue point of view—an attractive countermeasure that many countries would be absolutely justified in thinking about.

Meissner: I don't think we should extrapolate 100% from the past, but I would say that in the nineteenth century, tariffs were as much about restriction as revenue. When revenue got too high or too low, they adjusted the tariffs by fractions of the prevailing tariffs, so just percentage points of GDP. Tariffs were about 30% on average and didn't decline too much from that in the course of those years. There was a lot of restriction, a lot of lobbying, and some revenue issues.

To the parallel between the sterling area and what's going on now, from what I've heard, there's a paper by Stephen Miran about renegotiating long-term debt that reminds me, yes, of putting sterling balances on lockdown.

But there are other experts, like Catherine Schenk, on that, who should be here and be talking about that. So I'll just say that's interesting, and thank you.

Maggiori: Two remarks on what you asked me. The first is that you get lucky in these situations if the market starts signaling a problem and you have time to get to your senses. But there is no guarantee of that. In fact, we normally model these events as runs on a country because they look like a bank run. Everything is fine until it isn't. And what lures you into the big problem is precisely the absence of market signals. You can argue that in the last few weeks, we started seeing market signals with Treasuries and the dollar trading off the usual pattern with equities, and that we should come to our senses.

Really, you should have no confidence that the markets are going to give you a long leeway to see what is coming. The crisis might happen very quickly. You know the monetary system is really built on fiscal capacity and confidence, and confidence evaporates very, very quickly. We used to say the United States is the world banker and meant it as a positive thing: the US has large assets and liabilities. After 2008, we say the United States is a world banker; hence, it might blow up pretty quickly. You might get a run on the country, and that's a scary scenario, and you want to stay far away from it. And if you're a large debtor and you start mentioning not repaying, that's the quickest way to create a crisis. It becomes self-fulfilling as people worry about you. I'm very surprised to see officials talking about how we might not repay debt. Normally, the one piece of advice that we would confidently give is, please don't.

Similarly, accounting identities matter. I teach a class in international macro. There's some stuff that is pretty boring, like the capital account and the trade balance identities. You can't have a lot of net capital inflows but run a big trade balance surplus. That stuff seems to become fascinating again because people get it wrong. I used to teach it, and people were really bored. Now all the students want to know about it. Now I teach it, and it's in the *New*

York Times every day. It's the same thing as, no, inputs do not subtract from GDP. Yes, we write them as a minus in the accounting identity. No, it doesn't mean a negative effect. Getting those things right seems easy and a very nice thing to do in policy, compared to the usual space where we've done those things right, and what's left are the things that reasonable people might disagree on. I think a lot of the advice is on the basics. Let's just get those right, and we will live in a better world.

H.R. McMaster: To address Ross's question and Steve's earlier question, I think that we're not doing enough to counter Chinese economic aggression.

I think that's where a lot of the historical analogies break down because in the nineteenth and twentieth centuries, we didn't have a Chinese Communist Party that was really a Leninist system. We assumed maybe in the 1990s, early 2000s, that, to borrow a phrase from Dr. Evil [the fictional *Austin Powers* character], the Chinese Communist Party was the Diet Coke of Communism.

But they're not. They're the real Coke of communism. And they want to tear down the existing rules of international discourse and replace them with a new set of rules that is sympathetic to their system. I think you have to pay attention to a few things. What Xi Jinping says, what he does in terms of the economy, and with the buildup of the military. And I think these indicate that Xi Jinping is preparing China for war and is trying to use a lot of our lack of attention to how we're underwriting our own demise in his favor.

I think what we've done in the last five years, and going back to 2017, is to recognize the nature of the challenge. A lot of international investment flows into China, which were in many ways the scaffolding that was holding up their system, have dried up.

I think that's a positive indication. And I think there is a recognition that we have to put into place a strategy that integrates all the tools of economic statecraft and efforts of like-minded partners to counter various forms of Chinese economic aggression. To get to Steve's question on the tariffs, and the kind of jumbled nature of this policy, I think it would be really critical to clarify objectives, right?

Is it to generate revenue? Is it for national security? Is it to counter unfair trade and economic practices? I would say it's the latter two. I would recommend a few clear objectives that we should orient policies on. First, as I mentioned in the introductory remarks, we should not compromise the strength of our free market economic system, our sort of unbridled entrepreneurship, and our ability to mobilize private capital. We should not have the state be the allocator of resources.

Second, we should reduce China's coercive power over the US economy. Vladimir Putin had assumed that he had created a high degree of dependence on Russian natural gas and oil to a degree that he could do whatever the hell he wanted. We know from that case that it's a bad practice to give a hostile authoritarian regime coercive power over your economy.

Third, we should bolster the resiliency of supply chains that are critical to national security. Scott Atlas and I worked on a piece in 2020 at the height of COVID-19 on the degree to which we have allowed the pharmaceutical supply chain to be controlled by China. Of course, this applies to a lot of critical materials, some of which I think Christopher mentioned at the end of his brief.

Fourth, we should expand our defense industrial base to strengthen national security and ensure our ability to mobilize in wartime. We have seen our industrial base atrophy to an alarming degree. We have to do something about that. It's an urgent matter. Are tariffs part of that? Probably, but there are a range of other policies that I think would be even more important than tariffs themselves.

The fifth would be to counter Chinese economic aggression and to protect the United States's critical economic and defense-related competitive advantages. And this would include IP (intellectual property) theft, subsidization, and the vast overcapacity in dumping activities. We have to regain our footing in some of the critical supply chains and industrial bases.

Finally, to set policies that foster economic growth and innovation, we need an offensive-minded policy to take advantage of our free market economic system. I think that's what's missing. There isn't a discussion of what the heck we're trying to achieve with tariffs, and also with the broad range of tools of economic statecraft.

I do think there's a good team coming in. It's really important to understand that. I don't know how many people the Senate has confirmed, sixty or something, I think. So there are good people who are going to be coming into government in the Commerce, Treasury, and Defense departments who I think have very good ideas and strong knowledge bases on how to apply the tools of economic statecraft to accomplish clearly defined objectives.

I would expect to see a much better explained and more rational approach in the months ahead.