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Will the Centre Hold or Will it be Anarchy for the World Economy?

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The global economic outlook has become uncertain with all the extreme rhetoric of Donald Trump. Will this translate into action and is there a coherent strategy to deal with the fallout? Regardless, both the US and global economies face significant challenges that warrant concern.

United States President Donald Trump has emerged as an essential ingredient of a VUCA (Volatile, Uncertain, Complex, and Ambiguous) world, characterising the present state of the global economy. Trump has made a number of statements and taken decisions that defy traditional economic logic, in the process undermining the global economic order put in place at the end of World War II. Is the old liberal order then going to be replaced by the new mercantilist policies of trade war and tariff arsenals? Or, to invert Francis Fukuyama's 1992 thesis, is a new *End of History* being written now?

Tariff War

The US has imposed high tariff rates on Canada, Mexico, and China. However, in the first two weeks of March, Trump's decisions have fluctuated, swinging from whether to maintain them or raise them or lower them. There is now the additional threat that the US will impose "reciprocal" tariffs against trade partners.

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There seem to be two versions of the reciprocal tariffs being discussed. Initially, Trump said, "On trade, I have decided, for purposes of fairness, that I will charge a reciprocal tariff, meaning whatever countries charge the United States of America, we will charge them—no more, no less." Subsequent reports indicate that reciprocal tariffs will take into account many more factor such as taxes on American companies, government subsidies for foreign companies in their home countries, and regulations that prevent US companies from doing business in foreign countries.

Trump has also suggested that these tariffs will be imposed on countries with which the US runs a trade deficit. The tariffs on Mexico and Canada have been also linked to checking drug trafficking, particularly of Fentanyl.

If imposed, these new tariffs will be a clear violation of the most favoured nation (MFN) principle of the General Agreement on Tariffs and Trade (GATT)/World Trade Organization (WTO) rules that have governed world trade since the late 1940s. The MFN principle is based on non-discrimination among the WTO member-countries, and its violation may invite retaliation from other countries. If the issue is unresolved, it could undermine the GATT/WTO and lead to a full-fledged trade war among countries.

This is not the first time that the US has taken such a step. In the 1930s, the Smoot-Hawley Tariff Act raised duties on more than 20,000 goods with an aim to protect American farmers and businesses from foreign competition during the early days of the Great Depression. The tariffs triggered retaliatory tariffs from many countries, including Canada and the European nations. This led to a dramatic collapse in international trade, with global trade volumes declining by about 66% between 1929 and 1934. The Smoot-Hawley Act also led to a significant decline in US exports and imports and is seen as responsible for deepening the Great Depression of the 1930s.

The impact of the present US tariff hike will be more widespread in the globally connected world of the 21st century. Along with obvious implications for trade, there will be fallouts for monetary policy, exchange rates, and financial flows.

On a basic level, tariffs are duties on imports that increase the domestic price of imported goods. This gives domestic producers some advantage in competing with imported goods. However, a tariff also allows domestic producers to charge higher prices in the domestic market.

Suppose international steel can be imported into the US at $100 a unit when there is no tariff. Yet, domestic producers may be able to sell profitably only at $120 a unit. So, to protect the domestic industry, the government imposes a 50% tariff. This implies that imported steel will cost $150 a unit. Not only will this give domestic producers a respite from foreign competition, it will also allow them to increase their price up to $150 a unit. If there are still importers of steel, the government will collect customs revenues from them. However, higher steel prices will hurt consumers of steel, who will have to pay higher prices even for domestically manufactured steel. And all producers who use steel as an intermediate good will also face higher production costs.

Thus, if tariffs are imposed across the board by the US, as suggested by Trump, there will be an increase in the general level of prices, both for imported goods and import-competing domestic goods. This is likely to push up inflation in the country.

Immigration Policy

According to Trump's new immigration policy, the US is deporting undocumented migrants, tightening border controls with neighbouring countries, and introducing stricter rules for entry of migrant workers. These moves could potentially reduce the size of the US workforce. One possible impact can, therefore, be a reduction in overall demand in the economy, which will help in reducing inflationary pressures in the country. But it may also lead to an increase in wage costs.

The immigration policy is aimed at displacing immigrant workers and creating jobs for US residents. If this happens, it can be reasonably assumed that the US residents will demand higher wages for the same jobs. This will increase the cost of production and could push up prices in the US. Of course, there may be some positive impact on domestic employment, but the net effect on employment might be negative. There is also the possibility that machines or artificial intelligence (AI) will be used to replace high-wage domestic workers in certain industries.

Even in a developed country like the US, the labour market works with significant friction. It will be unrealistic to assume that employers will immediately find domestic replacements for the immigrant workers who have been deported. There is the possibility that the lack of suitable domestic workers will in the medium term lead to the closure of some businesses, which may reduce employment for domestic workers and impose a significant human cost in the short run (Tabellini 2024). At an overall level, studies estimate that stricter migration rules will raise inflation. However, the estimates of the extent of impact on inflation differ across studies (McKibbin et al. 2024; Edelberg and Steinmetz-Silber 2025). Also, even after treating the pandemic year of 2020 as an outlier, net migrants to the US have been falling (Table 1).

Table 1: Select Attributes of US Population

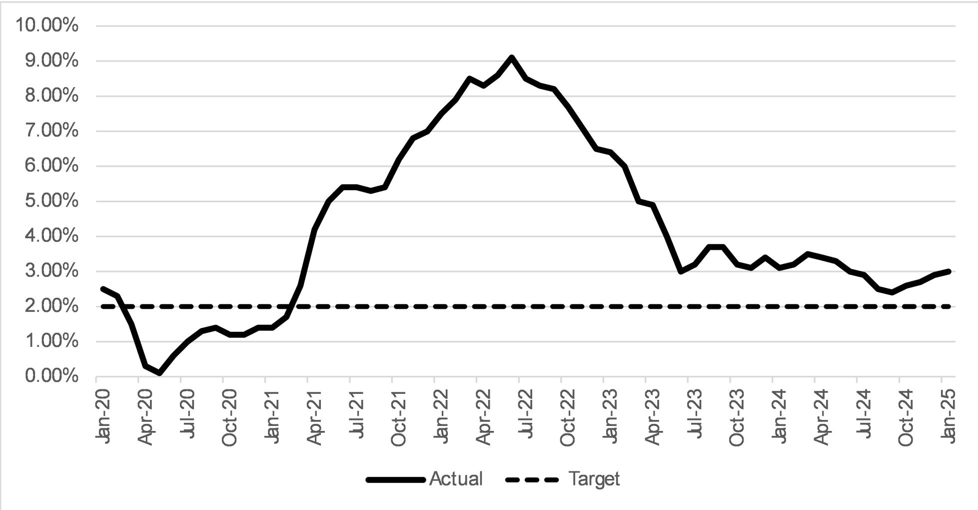
Year	Population (million)	Annual growth (%)	Migrants (net, million)	Median age	Fertility rate
1960	180.3	1.64	0.4	28.3	3.73
1970	207.8	1.21	0.7	26.7	2.52
1980	229.9	0.96	0.6	29.1	1.86
1990	253.4	0.95	1.1	31.9	2.07
2000	281.5	0.97	1.2	34.3	2.03
2005	295.7	0.99	1.4	35.2	2.04
2010	311.1	1.02	1.6	35.9	1.92
2015	326.1	0.95	1.7	36.4	1.83
2020	339.4	0.49	0.3	37.2	1.62
2022	341.5	0.40	1.3	37.7	1.67
2023	343.5	0.57	1.3	38.0	1.62
2024	345.4	0.57	1.3	38.3	1.62
2025	347.3	0.54	1.2	38.5	1.62

Source: Worldometer (www.Worldometers.info)

US Inflation

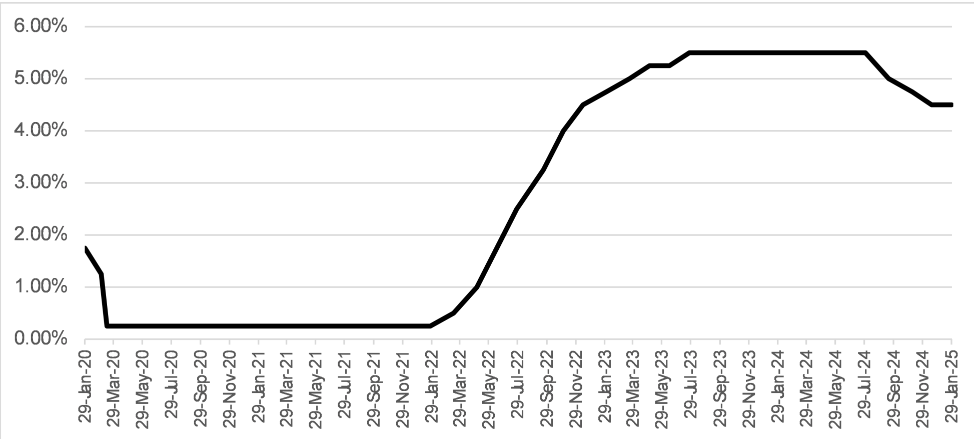
If inflation stays elevated, it will be difficult for the US Federal Reserve to reduce interest rates. In the regime adopted by the Fed, the target inflation rate is 2%. The US has not been able to achieve the target rate of inflation since February 2021 (Figure 1) and the Fed has cut the rate of interest and has not achieved the target (Figure 2).

Figure 1: US Monthly CPI Inflation



Source: US Fed Kansas City.

Figure 2: US Fed Rate of Interest



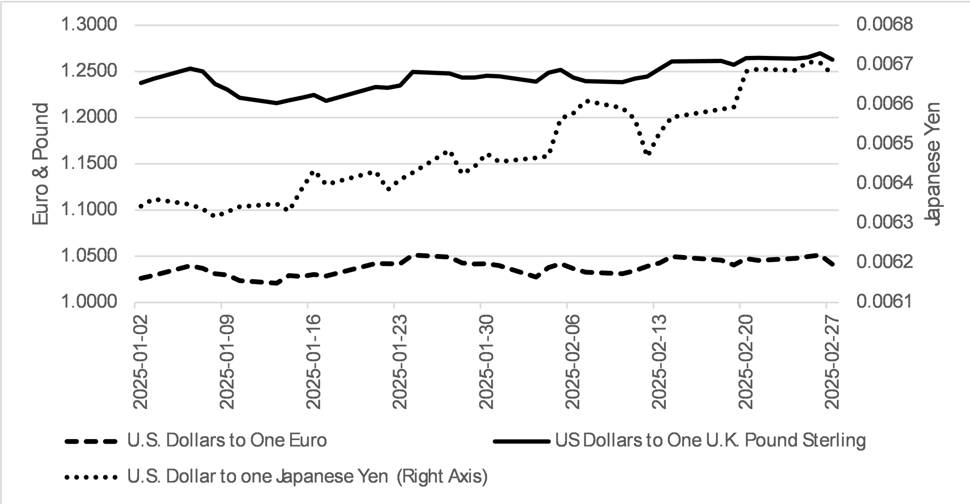
Source: US Fed Kansas City

With the prospect of higher inflation, it is unlikely that there will be rate cuts by the Fed in the near future. Reports indicate that Fed chair Jerome Powell feels that further cuts will have to wait until inflation cools more or until there is a notable softening of the job market. Neither of these is likely in a regime of tariff hikes and the anti-immigration policies.

Exchange Rate

Despite two rate cuts, the US dollar continued to strengthen in 2024. This can perhaps be attributed to factors such as a growth differential with other countries, or a monetary policy differential, or policy changes. Be that as it may, from trends in the first two months of 2025, it seems like Trump’s rhetoric and actions on tariffs and immigration is making the US dollar even stronger (Figure 3).

Figure 3: Exchange Rate of US Dollar vs Three Major Currencies



Source: US Fed Kansas City

A stronger US dollar could have two specific implications. First, it could be bad for the US current account deficit. Second, it might mean further depreciation of many emerging market currencies. Effectively, Trump's mercantilist policies, with all their irrational foundations, could make the phenomenon of the "exorbitant privilege" of the US dollar sharper.

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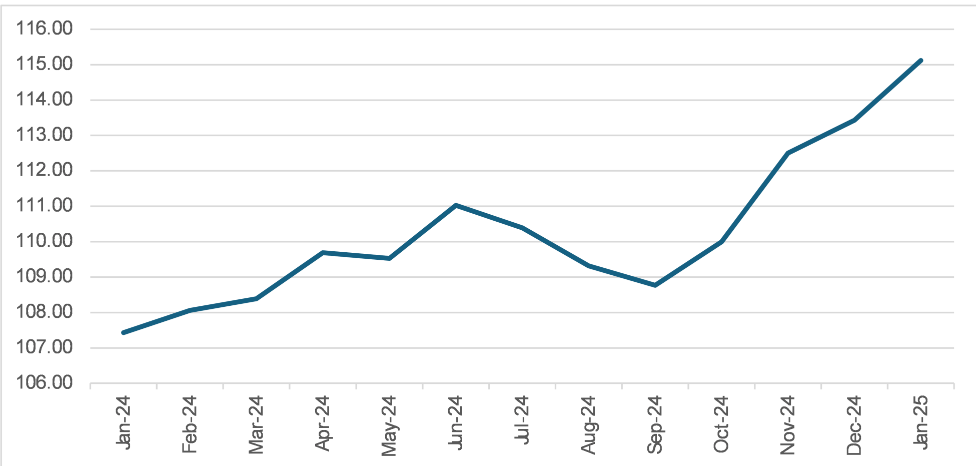
In reality, geopolitical uncertainties and Trump's tantrums have triggered outflows from different markets to the US dollar and led to a broad-based appreciation of the currency. The US real broad effective exchange rate (REER), which measures the dollar's value relative to a broad basket of currencies adjusted for inflation differentials, reached an all-time high in January 2025 (Figure 4). In fact, an appreciating dollar will offset some of the tariff increases planned by the Trump administration.

Figure 4: Real Broad Effective Exchange Rate for the US (Index 2020 = 100)



Source: Bank for International Settlements

On the other hand, an appreciating dollar will make US exports more expensive in the international market. The US is a high-wage country that is not globally competitive across a vast range of goods and services. If the dollar appreciates, US competitiveness will decline even more, which will negatively affect US industry's ability to create domestic jobs.

Not surprisingly, Trump advocates for a weaker US dollar. There are two problems with this. A weaker dollar may undermine the "store of value" of the dollar and may induce countries to de-dollarise. Financial investors also may not like a weaker dollar as it may affect their financial returns. Second, the US Fed cannot weaken the dollar without having to face inflationary ramifications in its domestic economy.

Bar on Central Bank Digital Currency

Till recently, the US was one of more than 130 countries (representing 98% of the global economy) trying to explore a central bank digital currency (CBDC) to take advantage of the rapid pace of technological change and to provide a viable alternative to cryptocurrency. A side story to the recent US economic policy idiosyncrasy has been its recent stance against a central bank digital currency.

A recent White House press release on presidential actions said, "Except to the extent required by law, agencies are hereby prohibited from undertaking any action to establish, issue, or promote CBDCs within the jurisdiction of the United States or abroad." Interestingly, the presidential order has formed a high-level working group on digital financial asset markets, and in line with maintaining the hegemony of the US dollar, is trying to promote dollar-backed stable coins as alternatives.

Way Ahead

As things stand now, the way ahead looks foggy. Commentators are speculating whether Trump's rhetoric will actually be backed by adequate action. They are also wondering if there is a method to these policy pronouncements. Overall, there are four signs of worry for the US economy:(a) the tariff war and its impact on US prices and the competitiveness of US firms; (b) the outcome of the new immigration policies and immigration restrictions; (c) increased inflation risks; and (d) the substantial reduction in government spending and large layoffs in the government sector.

The uncertainty surrounding government policies has already led to a sharp decline in consumer sentiment in the US. The University of Michigan's index of consumer sentiment declined by 10.5% in March 2025, falling to 57.9 from 64.7 in February 2025. These factors have increased the risk premium in financial markets, and as of 13 March 2025, the S&P 500 index closed in correction territory, having fallen more than 10% from its record high on 19 February 2025. Apprehensions of a recession are also there.

In explaining major disruptions, quoting W.B. Yeats' 1920 poem "The Second Coming", which says, "Things fall apart; the centre cannot hold/Mere anarchy is loosed upon the world", has become a cliché. Maybe such a cliché best describes the current situation.

The views expressed here are personal.

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