

Research @ Citi Podcast, Episode 30: Tariffs — The Global Chain Reaction

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Transcript:

Nathan Sheets (00:00)

I think trade war with China is probably an accurate description. And if there is an economic implication of it that I'm watching and worried about, it's that Chinese-produced goods are still a big part of many supply chains.

Rob Rowe (00:15)

Hi, everyone. I'm Rob Rowe, U.S. Regional Director of Research at Citi. Welcome to our Research @ Citi podcast. With me on the call today is Nathan Sheets, our Global Chief Economist, and the subject, if you're not tired of it by now, is tariffs. There's been a lot of developments here in terms of what is a dynamic situation of ever-changing tariff structures and tariff implications. And so we thought it would be a good idea to discuss them today and maybe to bring some context for everyone. Nathan, when you're thinking about these tariffs, bring it in context for us. Where are we? How extensive are these tariffs? And what do you think are the implications for not just the U.S. economy, but also the global economy at this juncture, at this point in time?

Nathan Sheets (01:02)

Yeah, great questions. And obviously, these are issues we spend a lot of time thinking about. My view is that the best way to kind of frame these tariff announcements is in terms of the overall effective U.S. tariff rate. And you can think of that as the tariff that's applied on average across all U.S. imports. When President Trump was inaugurated on January 20th, that effective tariff rate was around 2.5%. We then had some tariffs as a result of fentanyl on the border that were on China, also on Mexico and Canada. We had some auto tariffs. We had some tariffs on steel and aluminum. And that took that effective tariff rate up to 10%, into roughly that double-digit range. And then last week was the big announcement of the reciprocal tariffs, and a lot of numbers there are still being crunched and there are a few question marks and so forth. But at that point, the effective tariff rate looks like it was somewhere between 22 and 24 percent. Now, finally, there are two additional kinds of tariffs that we need to think. We're not done. First, President Trump has signaled that there are further sectoral tariffs on pharmaceuticals, on semiconductors, on lumber, and on copper that are very likely to be in train soon. And just for good measure, a 50% retaliatory tariff on China.

So I crunch all these numbers, I end up with an effective tariff rate somewhere between 25 and 30 percent. And the key observation here is these are the highest tariffs that the United States has seen in over a century, and we are seeing an economic policy implemented. There really—there's no relevant precedents to draw on to think about what kind of effects it will have on the economy. And I think as a result of that, the uncertainties are high, and you see that as the financial markets struggle with what these implications are going to be. Economists and others are struggling to think about what it means for growth and inflation. Central banks are in a similar place. We're all trying to absorb and quantify and calibrate a very large shock

to the economy, but we really don't have a lot of historical guides to help us with that. So that's why I'm thinking about this at the highest level.

Rob Rowe (03:33)

And at 30% tariffs, I mean, I guess you may be referring to Smoot–Hawley in terms of being a century ago. Those tariffs, I'm told led to a global trade war. What are the implications for the economies? When you have 25–30% tariffs, how much of that actually transfers through to, say, the consumer in the U.S., and are there things that firms will do to mitigate the potential additional cost? How do you— what is the implication for inflation and growth? Maybe we start there.

Nathan Sheets (04:04)

I think the Smoot–Hawley tariffs of 1930 are a good benchmark to kind of frame out some thoughts. Of course, the economy is much different than it was then. And by our reckoning, the tariff level may even be higher than it was during Smoot–Hawley. But in that episode, as you said, there was significant retaliations — the U.S. put on tariffs, and the rest of the world responded aggressively, and we had a global trade war that played a critical role in dragging down global demand and contributing to the global aspects of the Great Depression. Now I think there's a related thought that's absolutely essential that I think that makes this episode different than that and hopefully not as severe, and that is that there was one very significant retaliation. And we had a little bit of that back-and-forth and maybe even a meaningful amount of that back-and-forth between the U.S. and China. But I would be surprised still if many other countries want to go down that kind of path. So in the '30s, there was a lot of retaliation. But maybe even more importantly, the gold standard was in place. And so what that meant is, as all of this weakness in the global economy was being sustained, central banks had to maintain parities against gold, and they couldn't cut rates. And I think that in this episode, a clear policy prescription for central banks around the world, and the Fed, is it's a little different. But for central banks outside the United States, is to vigorously reduce interest rates and to ease policy. And hopefully that will defray and mitigate some of the very, very severe effects that we saw previously.

Now, for the United States, this is a two-sided shock. It is a stagflationary shock. It means that there will be higher inflation in the U.S., at least for a year or so, and weaker growth. And when we go to calibrate it, we'd say inflation, it could be a point to two points higher. I think there's a legitimate risk that we could see inflation over the next year touch — on a 12-month basis — touch 4% core PCE. So there are inflation risks, but there are also meaningful growth risks. And in that environment, whereas foreign central banks are cutting, the Fed has to wait and see: What's going to be more severe? Is it inflation? It may need to hike. Or is it growth? It may need to cut. Jay Powell is going to be watching closely, but I don't think he knows exactly what policy is going to look like, that these considerations are finely balanced. But both the growth shock and the inflation shock are worrisome.

Rob Rowe (06:52)

And at various times, the markets have been pricing in anywhere from, say, three to five cuts this year. Is that aggressive, in your view, given this sort of position that the Fed finds themselves in?

Nathan Sheets (07:06)

The way I would answer that is three to five cuts this year seems to me to be a plausible scenario. And it is a scenario where the growth effects of these tariffs dominate. And on

balance between growth and inflation, I am more worried about the growth side of the economy. And specifically, I think we're seeing — we'll continue to see — a lot of firms and households in the face of this tremendous uncertainty that I described, hit the pause button. Choose like the Fed. I said the Fed's going to wait and see. I think businesses they think about investment in hiring. They're going to wait and see, and households, as they think about large purchases are likely to wait and see. And as you have that hesitancy and economic behavior, it's likely to correspond to a weaker economy. So the three to five cuts that are in the market are plausible. It's a reasonable scenario.

But there is another narrative that the Fed has got to also stay focused on, given its experience over the last few years with high inflation, coupled with the fact that at the moment, inflation is still above 2%. And there's also a plausible chance that over time, that the inflation concerns are going to dominate. For example, inflation expectations could start to migrate up. Alternatively, tariff inflation should be concentrated in goods prices. That's where we should see the increase. But maybe it starts to bleed into services, and that's going to make the Fed very uncomfortable. And then finally, if inflation does kind of streak up through the threes and reach maybe even a 4% rate, at some point, it's going to feel like Jay Powell and his colleagues are reprising the transitory strategy, and this could start to undercut some of their credibility. So there's also a plausible scenario where the Fed's not going to have the scope to cut or where the inflation shock proves to be more severe. So this is a very kind of bimodal outcome, and I think that the markets are kind of pricing both sides, and I think that that kind of bouncing back and forth between these two very different scenarios is a key reason why we're seeing some of the volatility that we are right now.

Rob Rowe (09:21)

And, Nathan, I believe your growth estimates globally are not as— or the drop in growth is not as severe as the U.S., right? Can you explain why that's the case? And also, maybe we can then segue into: Is there a light at the end of the tunnel with tariffs? Is this a kidney stone we simply have to pass to get past it, and then what happens at the other end?

Nathan Sheets (09:42)

On the growth question, our estimate is that U.S. growth could very easily be one to two percentage points lower over the next four quarters than it would have been in the absence of the tariff. So a very appreciable shock. And then I would assess that for the global economy, that the effects are roughly half as large. Which I described them as being up to a percentage point lower growth. So we entered the year thinking global growth would be around 3, now I'm expecting it to be around 2%. So a full point below global trend. And the key reason why the rest of the world is less affected is for the United States, we just went out and tariffed all of our trading partners. For the rest of the world, it's just tariffs via-a-vis the United States. So it's only a part of their trade, whereas for the United States, it's the entirety of their trade. I think another difference, which is maybe not quite as significant, but still meaningful, is this difference in central bank response, where I said for the Fed, it's more wait and see. For the rest of the world, it's more a clear policies prescription where their economies are weaker, growth is weaker, inflation is weaker, and they should cut rates.

Now, in terms of your question about, is there a light at the end of the tunnel, I think the light at the end of the tunnel that the markets are focused on at the moment is the possibility that President Trump may put on his hat as negotiator in chief and use these tariffs as a bargaining chip to get concessions from other countries. My instinct is that he is still a negotiator at heart. One of his tariff announcements even had a section that was called "The Art of the International Deal". So I do think we will see negotiation. However, I have no confidence we're

going to see it in the next days or weeks. I think it's more a matter of months before we really get there. And I think President Trump, as a negotiator, no doubt is thinking if countries are willing to offer me this now, what are they going to offer me in a few months once the teeth of the tariffs are being felt to a greater extent? But negotiation is really the big light.

A couple of other just quick points. One, of course, there's substantial revenue that will be raised as a result of these tariffs. And how does that get used? If it gets used as tax cuts, that's going to support the economy and offset some of those growth effects. Alternatively, is a put against deficit reduction. I think markets would welcome that and would help bring down 10-year yields. And then finally, President Trump, I think, is still fundamentally committed to a deregulatory agenda that hasn't been front and center for him and that hasn't been his focus so far. But I do think we will see that, and deregulation is very likely to be stimulative for the economy, support growth, and also expanding supply and capacity and help bring down inflation. So that would actually be a development that would work in the opposite direction. So various kinds of scenarios where maybe in three to six, nine months, there will be some mitigants. But right now, this is a pretty painful episode. No questions about it.

Rob Rowe (12:59)

Yeah, and talking about painful episodes, obviously, the stock market hasn't taken this well. And I would say that the bond market may not be taking this well either. And we've seen some cracks in the structure, if you will. You know, there seems to be a potential buyer's strike in treasuries, and in the stock market, you know, obviously, there's been a big loss of wealth. Could the markets, if they got any more stressed, be a wrench in President Trump's plans that he would necessarily reverse anything out? And also, would it force the Fed's hand right now in terms of having to cut rates if these stresses were to continue?

Nathan Sheets (13:38)

So on the President Trump reaction function, I have to say one place where I have been surprised, and I think the markets have been surprised as well, is that President Trump has been quite impervious to the downward moves in the stock market. If you had painted this scenario for me on January 20th as President Trump was being sworn in, I would have said, you know, if he saw the markets go down 1,000 points, of course, hit a pause button on his tariffs, but he hasn't. And so, you know, there probably is some point at which this market tension, turmoil, and pressure prompts him to pivot more rapidly. And I think that's the way it would express itself is not so much a U-turn on the tariffs per se, but there's plenty of opportunities to negotiate. And could it accelerate the pace of those negotiations? Absolutely. And I think that that's something that we're all watching for, is how he has been impervious, but does that continue or is that kind of prodding him into negotiating more quickly?

On the Fed side of the ledger, I think very much what the Fed is looking for in this kind of an episode is about market liquidity and "market dysfunction". So gapping behavior. How are swap spreads? How is repo behaving? What are bid-ask spreads? On the run, off the run kinds of spreads? These are the kinds of things that they're looking at and monitoring. And if they do see evidence of illiquidity, And I think the Fed is likely to come in similar to the pandemic with significant firepower, but it's going to be focused on providing liquidity to the market. I think in this environment, it's going to be much harder, as I've outlined, where inflation is really a meaningful risk, and it's running above target. It's going to be very hard for them to also cut rates along with providing the liquidity.

Rob Rowe (15:41)

Lastly, Nathan, in regard to the relationship with China, I mean, tensions with China have continued for a number of years now. When the Biden administration, President Biden was in seat, they raised tariffs also against China and now these tariffs have risen to well over 100%, and China has committed to retaliating, saying, you know, we'll fight this to the end. What are just the implications on an isolated basis that we might see as a result of a continued conflict or— I mean, it almost feels like a full-fledged trade war with China.

Nathan Sheets (16:17)

Yeah. And I think trade war with China is probably an accurate description. And if there is an economic implication of it that I'm watching and worried about, it's that Chinese-produced goods are still a big part of many supply chains. And with these massive tariffs that are being applied, I think that those products that are incorporated in global sourcing — and there have been move to increase resilience and diversification of supply chains — we still import a lot of inputs from China, that these tariffs are likely to make that uneconomic and firms are going to be able to use those goods, they're going to have to scurry around and find new suppliers. And that could be a very disruptive process for firms, for global supply chains, could result in shortages and outages and opens the door to very significant questions about the evolution of supply chains going forward. So I think for me, that's probably the largest macro question that I have about this tension between the U.S. and China at the moment. And of course, in a geopolitical base, you can only characterize this as a further deterioration in the relationship between these two great powers. Do I think it fully forecloses the possibility that in 2026 or 2027, there could be negotiations? I think that door is still open, but it seems a long way off.

Rob Rowe (17:44)

Nathan, thanks so much for all of your insights. I'm sure everyone who's listening to our podcast will enjoy them. I certainly have. Thanks so much. This episode of Research @ Citi was recorded on April 9th, 2025.

[Disclaimer] (17:58)

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