Goldman Sachs Exchanges
Will tariffs lead to a recession?

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Allison Nathan: The Trump administration's tariff moves are turning US trade policy on its head and fueling concerns about the US economic outlook. So will tariffs send the US into a recession? And if so, what might that recession look like? I'm Allison Nathan, and this is Goldman Sachs Exchanges. Each month, I speak with investors, policymakers, and academics about the most pressing market-moving issues for our Top of Mind report from Goldman Sachs Research. I recently spoke with Paul Krugman, Jan Hatzius, and Oren Cass about what the radical shift in tariff policy could mean for the US economy.

I started off by asking Paul Krugman, who won the Nobel Prize in Economic Sciences for his work on international trade and economic geography, to give us some context on just how significant the Trump tariffs are.

Paul Krugman: There has been nothing like this. The story keeps changing, but it looks like we're looking at an average tariff rate that is a little bit higher than the Smoot-Hawley tariff of 1930. But Smoot-Hawley was starting off a base of quite high tariff rates. So the actual increase in Smoot-Hawley was a few percentage points on the average tariff rate.

Here, we're leaping from something like 3% average tariff to something like 20 or more average tariff, which is vastly bigger than Smoot-Hawley. And trade is about three times as big a share of the US economy as it was in 1930. So this is quite literally -- people have asked me when I say this whether it's a figure speech, but this is an order of magnitude bigger shock than anything that has ever happened in US history and, as far as I can tell, anybody's history.

Even when you look at developing countries that had very high tariffs for around 30 years after World War II, but they didn't get their all-in-one jump. So this is the biggest trade shock in history, as far as I can tell.

Allison Nathan: So obviously this tremendous trade shock has raised concern about recession in the US, maybe even beyond, but certainly in the US. Where do you stand on that? Is recession most likely ahead? Is it even inevitable at this point given the uncertainty?

Paul Krugman: Well, okay. My track record at predicting recessions is terrible, but no worse than anybody else's. I mean, there have even been studies. The success rate of economists at predicting recessions is approximately zero.

That said, this does look like a recession. But what's funny about it is that, if you asked me, "Do tariffs normally cause recessions?" the answer would be no. A tariff means that people buy less imported goods, but they might buy more domestic goods and it's not clear why that should lead to a recession. It has unpleasant consequences. It raises the cost of living. It reduces efficiency. But a recession is normally a collapse in demand, a collapse of spending. So you wouldn't expect tariffs in general to do that.

The secret sauce of the Trump tariffs is that they are extremely uncertain. Nobody knows what they will be. Nobody knows what comes next. Now, if you're a business trying to make plans, would you want to invest under those conditions? Suppose that you're considering you have a component plant in Mexico and an assembly plant in the United States or whatever, should you invest in Mexico? Well, not if there's going to be high tariffs. Should you invest in the United States? Well, what if the tariffs go away? Then it'll be uncompetitive. So anything you do runs the risk of having a lot of money stranded, and there's a tremendous option value to just sitting on your hands and sitting on your cash.

So this is unique. This is not the tariff -- a stable tariff rate would not cause a recession, but an unpredictable tariff rate that can change the next day is really a depressing effect on demand. And that's clear for business investment, but it also affects consumers. It affects home builders. So the uncertainty is the reason why a recession seems likely.

Allison Nathan: People assume, well, because it's so self-inflicted, the antidote is very obvious. You know, we just reverse policy. If we saw a quick reversal of policy, is that the answer here and then growth can rebound?

Paul Krugman: You know, in some ways, I almost think that the policy reversals, to the extent they happen, in some ways they make it worse because the reversal may be reversed a day or a week or a month later, so it doesn't make investing any easier because you still have no idea what the world will look like by the time your investment matures.

Allison Nathan: At this point, can you conceive of anything that would convince markets and consumers that the uncertainty is behind us? Is there anything that would restore confidence from that perspective?

Paul Krugman: It's hard because the thing about trade policy in particular is that, under the way it's set up in the United States, the law gives the president enormous discretion. No legislation has to be passed. No commitments need to be made. Which means that he can change his mind overnight. And we set up that system to create some flexibility around tariffs that were negotiated with other countries. We needed something that would let the United States respond if the political pressures became too great, but it was never intended to be used to make massive changes in trade policy. But that's what's happening now.

And so even if they said, "No, this is going to be our tariff policy and it will remain unchanged for the next three years," a week later they could say, "Actually, we've decided to change it." And who can guard against that?

Allison Nathan: So if we are talking about a likely recessionary scenario, will it be mild? Will it be deep? What is your best guess in terms of what this recession will actually look like?

Paul Krugman: It doesn't look all that severe given what we now know. Although again, this is completely uncharted territory. This is one of those situations where even historical comparisons, those are often your best route, but there is no comparison. So nothing like this has ever happened.

That said, the sort of focal point of the recession threat is probably business investment. And I guess I'd say it's mostly business investment in tradable goods, in sectors that are either competing with imports or exports, or things that are more strongly affected by the tariff regime. It's not clear to me why investments in health care, say, should be particularly affected by this. And our economy is probably about 75% non-tradable, so it's a limited set of stuff.

But within that sector, it can be quite severe. Now, business investment is a significant share of GDP, but not nearly as big as consumer spending. So you would think that this is a shock that produces, if it happens, a moderate recession. Although I think some of the wild cards here are: What about consumer spending? For consumers, there are fewer long-term decisions that are going to be whipsawed by all of this, but the effect on consumer perceptions, morale, we have seen the biggest decline in consumer confidence kind of ever, which is really quite remarkable because, so far, the economy isn't suffering all that much.

So we don't have soaring unemployment yet. We don't have soaring inflation yet, although the inflation is coming. But obviously, if you take the surveys at all seriously, people are extremely rattled. So if consumer spending falls off a cliff, yeah, then it can become a severe recession. So it is possible to tell stories where it's really very severe.

Allison Nathan: So Krugman thinks it's not the size of the policy shift that's likely to cause a reaction but the uncertainty around it. And he thinks that any policy reversals may actually hurt rather than help, given that the reversals themselves may be reversed at a moment's notice.

Next, I spoke with Jan Hatzius, the head of Global Investment Research here at Goldman Sachs and our chief economist. Hatzius also expects a large tariff-induced hit to US growth. And while he's not currently calling for a recession, he says that would probably change if the full slate of Trump's Liberation Day tariffs were to take effect.

Jan Hatzius: As it stands today and is reflected in our forecast for where the average tariff rate is going to go, we're expecting about a 16 percentage point increase in the average tariff rate. And in our view, that would be sufficiently bad to keep growth very weak this year. We have a baseline forecast of 0.5% fourth quarter to fourth quarter. We have a recession probability of 45%, so very close to 50/50. So it's very, very significant but doesn't quite shift the line for us to say recession is the base case.

Stepping back, if you take the roughly two percentage point hit that we're estimating from the tariff increase to GDP growth, which takes you from what we thought was a little bit more 2% growth for the year as a whole as we end at the year down to this 0.5% number, there are three components to the hit.

One is the tax-like effect of increases in tariffs on real income and therefore consumer spending. Number two is financial conditions tightening. We saw a very rapid tightening in financial conditions following April 2nd. That's pulled back to some degree, but financial conditions are probably still tighter than they were prior to the announcement. And then the third component, which overlaps a little bit with the financial conditions' impact is greater uncertainty among businesses who are less willing to invest in capital equipment basically because of the uncertainty, because it makes sense to wait before you spend on long-lived capital equipment.

Allison Nathan: What would lead you to move to a mainline recession call at this point?

Jan Hatzius: We were at 45%, and then the full reciprocal tariffs with the country-specific add-ons actually went into effect briefly. We moved to a baseline recession call. And then when the pause was announced, we immediately moved back to 45%. So there are a number of paths.

One is simply actually all of this does take effect. There is now a period of negotiations. If they fail and then for many or most or all of these countries you do actually get back to these numbers that showed up on the big placard on April 2nd. I think that would be a reason to go back to a recession call, depending on what else we see.

We're in a bit more of a data-watching mode here. We have an estimate of what all of this is going to do to the real economy but of course we're far from sure. And again, the uncertainty effect in particular is difficult to gauge. So over the next couple of months, we'll gain a lot of clarity in terms of what the damage to the economy really is.

It's going to be a little bit difficult in the short term because there are a lot of data lags and distortions that are going to make it difficult to assess. So we might be flying blind for a while, but two months down the road we'll have a much better picture.

Allison Nathan: Like Krugman, Jan believes a recession would more likely be moderate than severe, but Jan says this is because a potential policy reversal could stabilize conditions in the near term. Here's Jan and I talking about this.

So if we do end up in such a policy-induced recession, what would it most likely look like in terms of duration, severity?

Jan Hatzius: That's hard to know because obviously it's policy induced, which means that what policy does and what trade policy does in particular is going to be really paramount. And you could argue it shouldn't be that severe because once you do go into recession that's going to bring about a reaction. I tend to think that because, I mean, after all, we did see it move to a pause. So if you want to extrapolate from that, you would say, if you do go into a recession, if you actually see the recessionary data, they're going to pull back from that. But there's a lot of obviously unpredictability just in terms of how these decisions are made. And so that also makes it harder to assess how policy is going to respond to bad news on the economy.

So what does all that tell me? I would say more likely it's going to be a less steep recession because it can be, in some sense, probably turned off or at least reversed. But can't be too sure about it.

Allison Nathan: Well, interestingly, Paul Krugman, his take was that you just don't know if a decision to pull back is ultimately going to be temporary and that you could reverse a reversal. So he had a lot of concern about the uncertainty diminishing the ability of just the pullback in policy to be enough to avoid more sustainable damage and revert recessionary conditions if we get to that point.

Jan Hatzius: I don't disagree that there's going to be potentially ongoing damage from this, but, if there is a pullback, I do think it's still going to have a near-term positive effect. You know, I think maybe to some degree that effect diminishes the more times you go through one of these cycles, the smaller the effect.

But my guess would be that let's say over the next few months we get some really bad news on how the economy's performing. There will be a pullback. I think that pullback will stabilize conditions to some degree. Maybe you don't get a big bounce back. But I do think that, because it's a policy-induced recession if that's what it is, there is the ability to also at least stabilize things and keep you from continuing to contract at a rapid rate.

I think that is different from, say, an '08 type of situation where there's a reckoning in the financial markets and in the banking system and in the housing market, and the ability of policymakers to push against it is complicated because monetary policy is the main game in town, the funds rate is already at zero. There's just a limited amount that policymakers really can do.

The good news is that the funds rate is 4.25-4.5%, so we're not close to a liquidity drop or an effective lower vol situation, so the Fed could cut a lot in order to support the economy and stabilize financial markets as well.

The bad news is that these types of I'll call it stagflationary shock that push inflation up and growth down are just harder to deal with for policymakers because it's just hard to know whether we should mainly focus on the inflation or mainly focus on the weakness in growth. I think if the hit were large enough, even if you then have an even bigger short-term increase in inflation but if you saw a serious deterioration in the labor market, I have no doubt that the Fed would cut and probably actually cut quite aggressively because I think they would take the view, one, of course maximum employment is part of their mandate. And two, if the labor market is really, really weakening then that is going to suppress second round effects on inflation and therefore you can treat the tariff-driven price increase as more of a price level shift rather than the start of a serious bout of inflation.

So ultimately, I think the Fed's probably going to be a little bit late because of the difficulty of deciding between the inflationary impact and the real economic impact, but, if things were to really seriously deteriorate, they would do a lot and I think they would have quite a large impact.

Allison Nathan: Finally, I spoke with Oren Cass. Oren is the founder and chief economist of American Compass. He argues that, while Trump's trade policies will entail some short-term costs, there's no reason these policies would need to cause a recession. On the contrary, he says they should lead to a great deal of investment and better economic outcomes for America.

Oren Cass: I think the Trump administration has been very on point in focusing on what has gone wrong over the past generation with globalization, the realities of China's rise, and the shift to a multi-polar world and what that's going to mean for the US, both in terms of economic and security relationships, and therefore a recognition that things do need to change and there are costs associated with a change. But accepting some short-term costs in pursuit of a better long-term arrangement is a much better choice than simply sitting back and waiting to have things happen to us. So I think that's been very encouraging. And frankly, the fact that we have an administration that is willing to consider the long term and accept short-term costs in its pursuit is a very good thing.

I think most of the serious economists who are looking at this situation are recognizing that there are some ways in which these costs raise the possible risk of recession, but they certainly don't guarantee one. Markets certainly aren't signaling that this is some sort of catastrophic and unsustainable cost. And I think the reality is that the actual substance of the moves, if you think about how much of the economy actually depends on imports from these various places, what the implications of the tariffs actually are, what substitutes are available, the actual policies themselves are not sufficient to affect a substantial market correction or send growth negative on their own.

The question is much more what are the second-order effects likely to be? So for instance, what is the effect on consumer confidence, business confidence, and so forth? And that is obviously much less of a science. And so how the administration communicates things, what other developments occur, how markets do and don't react, how the media treats the entire story, all of that is going to have an effect, too. But there's certainly no reason that the kinds of policies that they are pursuing would lead to cause a recession. To the contrary, they should produce a great deal of investment.

I think that being said, there are a lot of very fair concerns with some of the specifics of how they have gone about it out of the gate in terms of the both the abruptness of a lot of changes and then in terms of the lack of communication about what the actual long-term goal is. And so I think it's very understandable that allies are frustrated in a lot of cases. It's understandable that markets are frustrated in a lot of cases. And I think you're seeing the administration start to try and correct course.

Allison Nathan: Am I hearing you correctly that, if the administration gives more certainty, as you think they have begun to do, do you think that's going to lead to a better near-term economic outcome? Or are you saying we might still have near-term economic weakness as this short-term wiring takes place?

Oren Cass: There will be short-term costs regardless. I think some of those short-term costs are associated with the rewiring. I mean, one thing I remind folks is that typically when you're talking about here are some short-term costs we need to incur to achieve some long-term benefit, we refer to those short-term costs as investment. And in some respects, it's literally investment. We're talking about needing to divert more resources to the development of productive capacity. And so certainly in the short term, that is a cost but it can be a very worthwhile one.

I think there is also a cost potentially from the market perspective in terms of reduced profit expectations. Obviously, globalization and easy access to cheap labor was very good for multinational corporations' profits. And if we are reversing course on that, it might be perfectly natural to say that equity values and expectations of forward profits are going to be somewhat lower. So from some perspectives, that may be a cost but that's also a great example of a place where the stock market does not provide a useful proxy for the actual well being of the country or the strength of the economy.

Allison Nathan: Some people have actually argued, though, that the ability of companies to generate strong profits is an important pillar of the US economy's strength. So what would you say to that?

Oren Cass: Well, going all the way back to *The Wealth of Nations*, Adam Smith said the rate of profit is always highest in those countries going fastest to ruin. The broader question of whether the United States is a good place to do business I think is a very important one. And the reality is that, in a lot of ways, what has happened with both globalization and financialization over the past few decades is that we have made America a much better place to earn a lot of money but in ways that don't necessarily generate any of the positive benefits for the country that are the reason we want businesses to be here and succeeding. And so I think what the agenda ultimately comes down to is wanting to reestablish that linkage between successful, profitable businesses and activities that actually are good for the people who actually live here in this country.

The place where I have less sympathy about the uncertainty narrative is that, while there are a lot of variables floating or there in the ether, the reality is that, almost regardless of how those are resolved, the required strategy or the dominant strategy in response would be to be investing significantly more in US-based production. None of the outcomes on the table are ones where you would wish you'd focused more on offshoring or hadn't been focused on figuring out how you could do more domestically. And so to some extent, I think there is a "doth protest too much" dynamic to a lot of the largest corporations that are still looking for excuses not to do that.

Allison Nathan: What do you say to people, though, who say, "Well, but what if the tariffs are negotiated lower through a trade deal or four years from now we have a different administration who goes back to the prior tariff regime? What then?"

Oren Cass: I think there will probably still be plenty of policy changes in various directions, and so the challenge for business leaders is always what is the best and most plausible course and what is the one that is likely to work out, all things considered? You know, nobody hesitated to rush all of their investment to China as soon as it was granted WTO membership, notwithstanding the obviously massive risks associated with sending all of your investment into a state-controlled market. And of course, in some respects that worked out very well in the short run. And in a lot of respects, a lot of corporations had absolutely had their lunch eaten in the medium to long run. But they all seemed really fine and comfortable doing that.

And so this idea that we just can't operate in this world of less-than-perfect certainty about the geopolitical conditions for the next 30 years is I think a little bit lame.

Allison Nathan: Let's leave it there. I'd like to thank Paul Krugman, Jan Hatzius, and Oren Cass for their insightful comments. And thank you for listening to this episode of Goldman Sachs Exchanges. I'm Allison Nathan.

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