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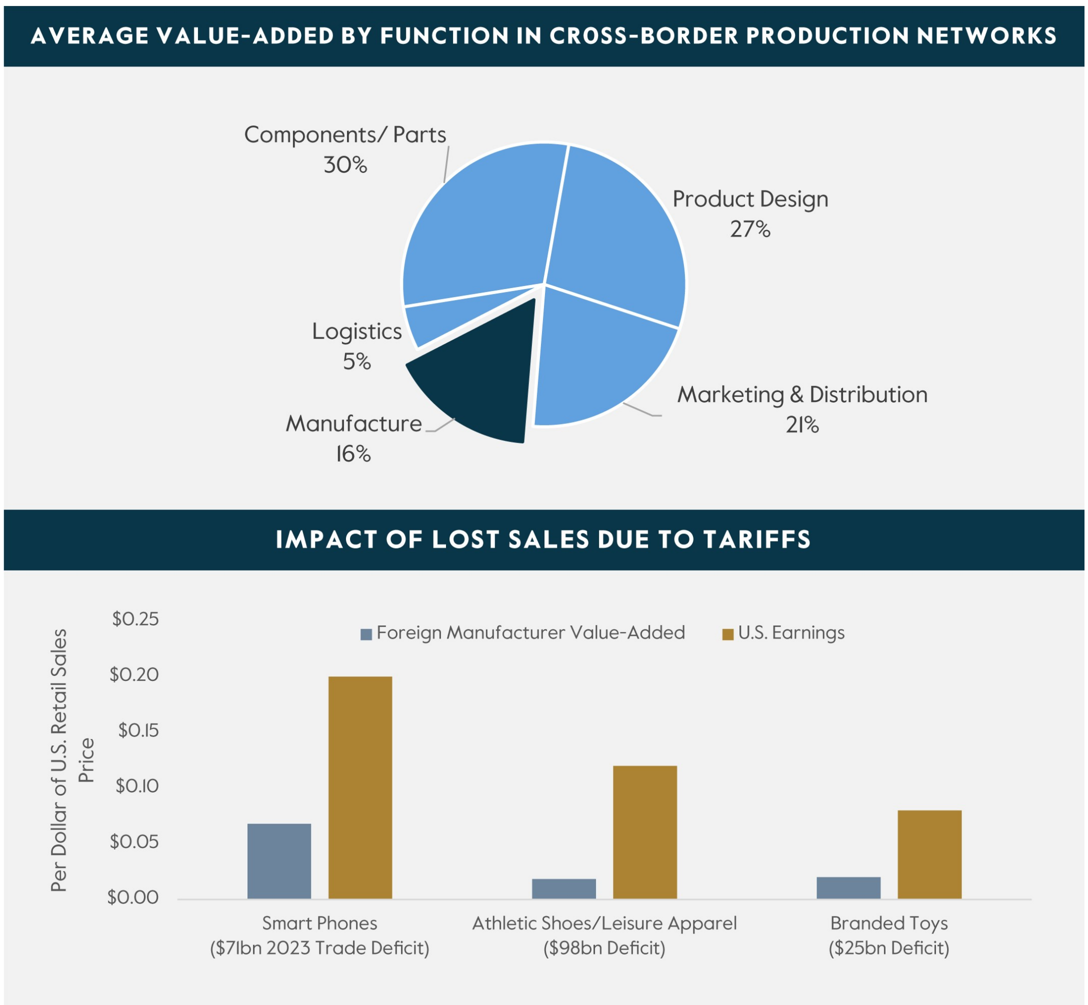
Tariff Paradoxes

I am mentally exhausted from thinking about tariffs, but when I read the news, I am surprised that anything else merits mention.

The biggest loser from the imposition of U.S. tariffs is the U.S. corporate sector. In many product categories, every $1 of the exporting economy's GDP lost to tariffs translates to between $2 to $4 in foregone U.S. earnings (Figure 1). This isn't much of a secret. When markets were "crashing" in response to the initial "Liberation Day" tariff schedule, Secretary of State Rubio explained that was "because markets are based on the stock value of companies who today are embedded in modes of production that are bad for the United States."

These "modes of production" involve an industrial organization where domestic operations focus on the highest value-added activities—product design, development, and (especially) branding—and third parties (often located in Asia) contractually perform much of the manufacturing. The strategic orientation of the U.S. corporate sector yields two paradoxes: (1) Despite the large bilateral trade deficit, there are far more U.S.-branded products sold in China than there are China-branded products sold in the U.S.; and (2) near-term reductions in the U.S. trade deficit require that U.S. consumers cut back on buying so much U.S.-branded merchandise.

Figure 1: U.S. Imports Embed Significant U.S. Value-Added



Source: Carlyle Analysis of Census Bureau Data. Federal Reserve Bank of Dallas, The Berkeley Roundtable on the International Economy, de Gortari Alonso (2019). "Disentangling Global Value Chains," December 2024. There is no guarantee any trends will continue.

It's also interesting to consider that there is nothing foreign governments could plausibly offer in negotiations that is of greater near-term financial value for most U.S. businesses than a reduction in U.S. tariffs. And so, by entering negotiations to secure tariff relief, foreign governments effectively serve as emissaries of U.S. businesses.

The U.S. delegation to those talks may play a similar role for foreign counterparts. In many economies, the most significant "non-tariff trade barriers" are labyrinthine and capriciously enforced regulations that also cripple domestic industry and entrepreneurship. Eliminating them in response to U.S. demands could bring more growth-enhancing "structural reform" to these economies than any IMF program ever has.

The situation in the auto industry differs from other areas in that much of the trade deficit is explained by U.S. purchases of foreign-branded vehicles, largely Japanese, Korean, and German. But even here, U.S.-branded products make a large contribution, with GM importing over half of its domestic sales and domestic value-added covering just over half of the Big Three automakers' U.S. sales. While nearly every automaker serving the U.S. market has a large physical presence in the U.S., these facilities typically depend on imported parts, 41% of which are sourced from Mexico. By increasing the cost of inputs necessary to manufacture at these facilities, the new tariffs on auto parts that took effect May 3 reduce the return on automakers' physical capital in the U.S.

There are lots of loose ends here; it feels dangerous to assume that nothing will go wrong because nothing much has yet gone wrong. Tariffs have thus far had a minimal impact on domestic pricing, production schedules, and employment precisely because management teams are behaving as though some tariffs will go away and others will stay at manageable levels. (The massive inventory of intermediate goods accumulated in Q1-2025 affords them this luxury). Markets' performance similarly reflects optimism that the Administration will reach "deals" that keep 10% tariffs in place and reduce other country or product-specific duties.

There's nothing magical about 10% tariffs, but they do seem to operate in a linear state space, where import prices, retail prices, and volumes can all adjust modestly to yield a new equilibrium. Tariffs of 25% or more, by contrast, introduce a shock to the system whose ramifications are much harder to anticipate.

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