

Linking Trade and Currency Dynamics

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- Trade and exchange rates are unique features of our international economic order. To talk about them, you need to understand international economic law. International economic law is about two words that have become shun/tion words. They can make some people cringe. Politicians don't like them because they don't poll well. In fact, they are a unique source of strength and vulnerability. Those words are **globalization** and **regulation**. Regulations are a made by people. Globalization is largely a market phenomenon driven by the human impulse to explore, exploit and connect. It is a source of great strength and vulnerability. Countries that get it right can be masters of the universe, get it wrong and you flounder. My message today is that we need to renew our efforts to get it right.
- **Where are we? How did we get here? Where are we going?**
 - o We are a quarter century into the century of crises characterized by a systemic failure in the Global Financial Crisis and a host of mini crises.
 - o We got here through fifty years of building out the systems of trade, money and finance into what we call the global order.
 - o I see three scenarios worth considering for our future:
 - **The J curve**
 - **The brave new world**
 - **The prospect of systemic failure**
- The scenario I want to spend the most time on is the prospect of a systemic failure but before I do I want to highlight some important themes.
- **Trust and Systems of Trust** – Trade, Money and Finance are in essence systems of trust characterized by complex interactive networks of private and public sector transactions, connections and interactions, grounded in law and norms and supported by private and public institutions that operate, extend, improve and repair these networks.
- **Systemic Failures** used to be limited to the financial sector punctuated by bank failures. But as I wrote in an article in 2010, there is no reason to limit systemic

failures to finance. I believe systemic failures are relevant to the systems of trade and money as well. All systemic failures in finance, trade and money involve a breakdown in trust, not some kumbaya, chanting type, but the kind of trust that conveys power and influence and conversely strips those away when there is a failure of trust.

- **Law and Trust:** I think the most interesting question for this discussion is the relationship of law and trust. As Frank Cross wrote in his 2005 article,¹ law can either build trust, or it can displace trust. For some, excessive regulation can both demonstrate a lack of trust and undermine trust. For others, law enables trust to be built out over time and geography, thereby providing the essential glue that keeps a global order functioning over time and space, allowing commitments in one corner of the globe to enable transactions in another, allowing one generation to finance the well-being of another.
- **The power of narratives** – narratives are now more critical than analysis because narratives are at the heart of the political economy. We live in a post-modern world where truth is relative, your truth is not my truth. The dominant narrative is what counts.
- This set up takes me to the most important question: **Who do you trust?** I believe your futures and your very lives depend on how you answer that question.

So, let's play around with some of these ideas.

First, what does any of this have to do with tariffs and exchange rates?

You may not know that the origins for this panel go back to 2010 when Aluisio was obsessed with currency manipulation and he wanted to know why something so fundamental to the functioning of trade and money was not governed by a set of norms? What he found out was that in the early 2000s there are norms under both the IMF and the WTO that were supposed to discipline currency manipulation (particularly by China), but they were not being applied, in large part because these two institutions were incapable of cooperating on something so fundamental. I think this failure dealt a significant blow to the credibility of both these global institutions best understood as a loss of trust in their inherent capacity to manage globalization.

I think the most interesting question we are facing today is what is the future of the dollar? Most people see this as a question of confidence. I see it as a matter of trust.

¹ Frank B. Cross, *Law and Trust*, 93 Geo. L.J. 1457 (2005).

- Barry Eichengreen has explained that trust in the dollar comes from our rule of law, stable institutions and the depth and sophistication of our capital markets that make dollar assets the best choice of safe assets.
- Other factors include geopolitics, inertia and network effects, (relative) fiscal stability and the lack of other alternatives even as other currencies from the Euro to the RMB and crypto currencies pose a significant threat.
- The BIS in its triannual currency report this April confirms that 90% of global transactions involve dollars so the market is continuing to give a solid vote of confidence in the dollar as a reserve currency even as central banks have reduced their holdings of dollars in favor of alternatives, especially gold. This raises the interesting question whether the vectors of trust work differently across governments versus markets and how do those trends interact with one another. What influence do markets have on governments and vice versa?

Now, let's come back to my scenarios for where we go from here:

- Peter Baker and Susan Glaser wrote their book on the first Trump Administration and called it: *The Great Divider*. I think if they write a book on the Trump 2.0, it will be called *The Great Destroyer*. For our purposes, the most important dimension of this assault is his attack on the foundations of globalization from trade and the WTO, his new version of reciprocal tariffs, to his desire to rein in the independence of the Federal Reserve and to champion crypto as an alternative currency. Some argue that this is creative destruction, others think it is destructive destruction.
- So where are we going from here. I see three scenarios.
 - o The J curve scenario: this scenario builds on the notion that significant change in one factor (exchange rates or tariffs) can take time to translate across the economy. The fact that Trump's disruptions of trade and money have not significantly impacted inflation and economic growth is a matter of time not direction. Inflation, lower growth and economic stagnation are coming and when the trend kicks in, it will be very difficult to reverse it as we saw in the 1970s.
 - o The second scenario is what I call the Brave New World Scenario. As George Orwell said in 1984: "Who controls the past, controls the future. Who controls the present controls the past." On this scenario, the macroeconomists are all wrong, and the world is turned upside down because technology, deregulation, the demise of the state will all lead us to the New Renaissance of low inflation, high growth and prosperity.

- The third scenario is what I call the Systemic Failure Scenario. That scenario builds off the observation that we are in the century of crises that have become systemic to varying degrees. What we know is that we will encounter another crisis – could be climate change, geopolitical conflict, financial breakdown, pandemic or solar eruption – and the question will be who can we trust to manage such a crisis? Where are the safe assets and who are the safe asset managers?

We don't have time to explore all these hypotheses so I would like to take a brief tour through the worlds of trade, money and finance with the suggestion that we are already seeing a kind of slow motion train wreck that is taking place in plain sight and involves a catastrophic gap in the relationship between revenues and expenditures for the US Government. I want to use this lens to consider developments across trade, money and finance.

Trade

Trump has turned the entire trading system on its head by recasting tariffs as a “life or death” issue for the US economy. There is some irony here for the macro economists. For almost a century, it has been an article of faith that the Smoot-Hawley Tariffs were the cause of the Great Depression, despite the good work of Barry Eichengreen and Doug Irwin whose analysis showed that it was monetary policy – not trade policy – largely to blame. Now Trump is arguing to the Supreme Court that the removal of tariffs will cause another Great Depression. Moreover, it looks like Trump got out of sync with his Solicitor General over whether tariffs are important revenue measures with John Saur arguing that they are essentially regulatory in nature and would work best if they were purely regulatory and just provided protection and not revenue. Meanwhile, Trump has claimed that they not only can help solve the deficit problem but could allow a cash bonus of \$2,000 for every citizen.

The Supreme Court now must decide who to trust or at least whose narrative to trust?

The oral argument suggested the emergence of an unholy alliance between the liberal and the conservative justices, united in opposition to the abuse of Presidential power in applying tariffs that are, in essence, taxes. While regulation of importation might include the power to tariff (as in the Commerce Clause), it does not include the power to tax. A tariff that is a tax is no longer a tariff.

I spent a good part of my career on the elimination of tariffs on semiconductors and computer parts so I know what disruption this shift can mean for supply chains and business models, especially if you consider that inexpensive chips made possible the information revolution, the dotcom economy of the 1980s, the internet and now AI. Moreover, tariff elimination was part of an entire suite of industrial policy measures to sustain our start-up chip companies like Intel and AMD as Ronald Reagan signed into law measures like the R&D tax credit, antitrust exemptions for joint research and development, intellectual property protection for mask works, and Sematech subsidies for joint R&D.

But at the same time, we would not have achieved the US-Japan Semiconductor Agreement without threatening the Japanese with 183% tariffs on their semiconductor exports to the US.

My point is that I have no difficulty seeing tariffs as both regulatory and fiscal. Indeed, I was a student of John H Jackson who had this to say:

“Tariffs, though often described as fiscal instruments, serve primarily as devices of trade regulation. Their economic and legal significance lies not in the revenue they raise, but in the way they shape the conditions of market access and the competitive relationships between domestic and foreign producers.”

— John H. Jackson, *The World Trading System* (2nd ed., 1997), p. 62.

I don't think there is any question that the Trump reciprocal tariffs are abusive and indeed that seems to be the real challenge facing the court. If Biden had imposed 10% tariffs to leverage countries to sign a climate change agreement, I don't think the liberal justices would have problems seeing tariffs as regulation of imports as the court did in the *Yoshida* case. Now, the bigger question is: what are the implications of a decision to overturn the tariffs and force the Administration to rebate all the tariffs. Neal Katyal argued that we have an orderly procedure for that, but we have never tried to run \$195 billion through those channels. More importantly, what does this say about where we can find the revenue to begin to address the debt crisis? We can't tax income because taxpayers don't like to pay taxes. We can't tax capital because it is mobile. We can't use sales or VAT taxes because they are regressive. And now we can't tax good coming across the border.

Money

Let's talk about money. I mentioned the scenario in which up is down and down is up. That seems to be the case when we talk about exchange rates and interest rates. The imposition of tariffs was supposed to strengthen the dollar. In fact, since liberation day, the dollar is down (somewhere around 8% for the year). When the Fed cuts rates, long term rates are

supposed to come down but they are up (by some accounts as much as 100 basis points from where they should be).

What does this say about confidence in the dollar?

I want to start with a thesis from Ken Rogoff's new book, *Our Dollar, Your Problem*:

“The era when the dollar was utterly dominant and reliably stable may have passed its peak, the result will be a rise in the number and intensity of debt, financial and exchange rate crises.” (Quote from Jason Furman reading at PIIE lecture.)

“Money is power. There is no question about that. One point that I have lot on is this whole idea that you can be a reserve currency without being a global military power is a joke. I mean there are lots of reasons for that, some very crude reasons, some subtle ones.”

Comments at PIIE address, September 19, 2025.

Larry Summers on why we are going to keep our reserve status: “Europe is a museum, Japan is a nursing home, China is a jail and Bitcoin is an experiment.”

What about the independence of the Fed? (This discussion comes from the conference on independence of the Federal Reserve held at the Peterson Institute on October 31, 2025.)

Lots of talk but the question for me is independence from who or what?

The main concern seems to be that if the Fed is politicized, it will be more likely to lower interest rates to encourage growth in the face of inflationary pressures that will then lead to more inflation.

The other concern which may be more serious than even inflation is who gets the bailout from the lender of last resort? The list of candidates is long as we will see in a moment but after AI, private credit, crypto, etc., there stands the US Government.

John Cochrane captured the point by saying that the hard problem facing the Fed is how to respond to the fiscal challenge. The issue going forward is does the Fed resist fiscal pressures to inflation or are there rules that prevent the Fed from indulging its instincts to provide funding in the event of a crisis. As Cochrane argues, the tough message from the Fed is “you government, you gotta raise tax revenues, you gotta cut spending, you got to enhance economic growth, you got to let some crises burn and we're not going to print money to bail out this fiscal problem.” That's going to be the hard one going ahead and you can't just put it on the independent fed, you must be very clear that that's what you want out of the Fed, and those rules need to be very clear and very strict.

Finance

So, let's talk about the financial system.

Gita Gopinath raised the alarm about the stability of the financial system at the recent IMF meeting in which she highlighted the threat from US equities, and particularly the prospect of a bubble from inflated valuations around Artificial Intelligence. Her point was that if we saw an equity adjustment on the order of the Dotcom bubble, we would see a \$21 trillion loss of wealth that would affect not only US equity holder but there would be global impacts because of the global holdings of US equities. Her paper was highlighted by the Economist and now the Economist has further elaborated on her point with its cover this week: "How Markets Could Topple the Economy."

Gita concentrated her fire on AI and inflated equity prices, but there are other candidates for possible bailouts. Remember what happened in 2008. I remember it well because I retired from GE in February 2008 just before the commercial paper markets seized up. There is a great story in Bill Cohan's book, *Power Failure*, in which he describes the trials Jeff Immelt faced in trying to convince Hank Paulson and Sheila Bair that the commercial paper market was a fundamental part of the financial plumbing and needed the kind of guarantees that were being given to money market funds. Fast forward to February 2021 and we find the Fed buying corporate bonds through the Primary and Secondary Corporate Credit Facilities.

The line for possible bailouts in today's world starts with AI and goes on to the private credit and crypto markets. By some accounts we are seeing average investors attracted by the appeal of private credit which are being sold as less volatile than public credit markets but they are buying into same leverage on leverage that was the case with mortgage backed securities in 2004-2007 where BBB credits were turned into AAA credits that people thought provided higher yields in safe assets until it became clear that they were toxic assets.

So, the question is what happens if we have another market induced financial crisis as The Economist is suggesting. More troubling is what if this comes at a time when the US Government is issuing record amounts of Treasuries at a time when the market may have less appetite for US Government debt.

Would the Fed have the bandwidth to deal with such crises individually or in tandem?

What could the US Government do in the face of such a scenario? The classic solution involves financial repression by monetizing the debt inflating our way out of the problem. Other proposals involve charging the coupon on the Treasuries or somehow moderating long-term rates as Stephen Miran has stated is the third mandate of the Fed. The US could

embrace new revenue sources like a Value Added Tax. All of these involve very significant political and economic repercussions and a challenge to our governance capacity.

Conclusion

Whatever your perspective on the future of the economy, there is almost certainly going to be some surprises. The old Chinese adage: “may you live in interesting times” seems apt. In 2008, we saw that in a crisis, plan trumps no plan. Who do we trust to have that plan?