Bi-Weekly Geopolitical Report

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August 25, 2025

Tariff Trilemma: The Three Rs Driving US Trade Policy

Not all tariffs are created equal. Throughout the history of the United States, tariffs have been employed to achieve three primary objectives: (1) to pressure other governments into lowering their own trade barriers, (2) to generate revenue, and (3) to protect domestic industries. While ideally these goals would be achieved simultaneously, trade policy often presents a "trilemma," where pursuing two of these objectives comes at the expense of the third.

This report explores the distinct types of tariffs, their impact on financial markets, and what recent trade developments indicate for the future of the American economy. As always, we wrap up with the implications for investors.

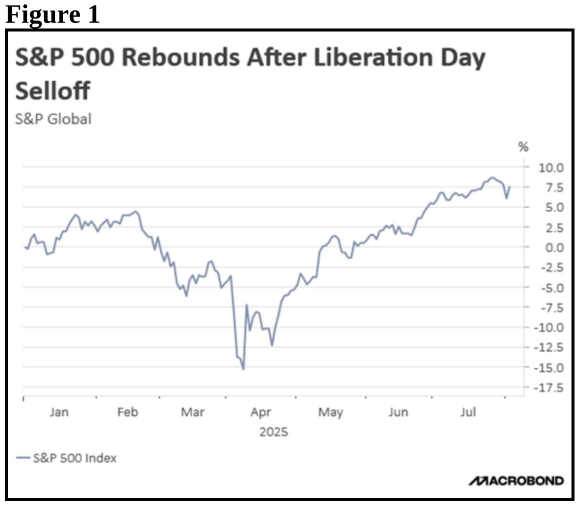
A New "Liberation Day"

On April 2, President Trump announced a dramatic transformation in global trade policy. Having campaigned on the argument that the US had been systematically disadvantaged by unequal trade relationships (where foreign imports flooded American markets while US exports faced barriers), he declared that this imbalance demanded immediate and decisive action. His administration implemented what it referred to as "reciprocal tariffs," imposing carefully calibrated rates intended to rectify what President Trump characterized as fundamentally unfair trade imbalances.

While the president framed these "Liberation Day Tariffs" as corrective measures for perceived trade inequities, he simultaneously revealed their broader strategic purpose. Praising tariffs as "the most beautiful word in the dictionary," he positioned them as dual-purpose tools that could revive domestic manufacturing while generating revenue to enrich the country.

The market's reaction to this new era has been telling. After an initial panic following the decision to raise tariffs, US stock prices have rebounded to new highs (see Figure 1). This suggests that investors' fears were less about the existence of tariffs and more about the specific kind of tariffs being implemented. Therefore, understanding the different types is essential for gauging which trade policies will ultimately affect market performance.

Figure 1



The Three Rs of Tariffs

In his book, *Clashing Over Commerce*, author Douglas Irwin simplifies the complex world of trade policy by outlining three types of tariffs, which he calls the "Three Rs": ***reciprocal***, ***revenue***, and ***restrictive***. Each serves a different purpose and comes with its own unique set of pros and cons.

Reciprocal tariffs generally have the lowest rates and typically function as a bargaining chip. Also known as "tit-for-tat" tariffs, their aim is to persuade other countries to lower their trade barriers in exchange for similar concessions, opening foreign markets for domestic businesses. The primary benefits include a broader consumer base for domestic firms, access to a greater supply of foreign goods that helps lower prices, and increased trade certainty that improves business planning.

However, these tariffs carry significant risks. They often lead to a greater dependency on foreign supply chains, making the economy susceptible to supply shocks. Furthermore, the incentive for firms to use lower trade barriers to outsource labor can lead to job dislocation in vulnerable sectors. This was most visibly seen in the American manufacturing sector, where the share of jobs shrank from nearly 40% of payrolls in the 1940s to less than 10% today.

Revenue tariffs are considered the "Goldilocks" of trade policy as they are set neither too high to choke off imports nor too low to be fiscally insignificant. Their main purpose is to generate government revenue, which can help service the national debt. By design, they keep trade flowing and give the government a vested interest in protecting global commerce to ensure a steady stream of import duties.

Their main drawback is that government finances can be adversely affected if consumers reduce their purchases of imports. Additionally, finding the ideal tariff rate for each country can require constant and complex negotiations to maintain optimal revenue levels.

Finally, ***restrictive tariffs*** are the highest and most protectionist. Their explicit goal is to limit the flow of imports to shield and promote domestic industries. The potential upsides include the development of new domestic industries and greater supply chain resilience by reducing dependence on foreign nations for critical resources.

However, the negatives are often immediate and severe. Restrictive tariffs can cause short-term supply chain disruptions as firms scramble for suitable domestic substitutes, which can lead to shortages and price instability during times of high demand. Critically, this aggressive approach is the most likely to provoke retaliatory tariffs from other countries, risking a broader trade war.

Which "R" Is Driving Policy?

As shown above, each of the three Rs has certain desirable characteristics, and the US has employed all three at different times in history. The most recent tariff shift has been aimed at sending a message to the rest of the world that the US is "closed for business."

When President Trump took office for his second term, he entered with a mandate to fix the US trade imbalance with the rest of the world. To achieve this, his "reciprocal" tariffs introduced two tariff benchmarks: one reflecting the rates the US would impose on its trading partners, and the other representing what he believed the rest of the world was charging the US.

Contrary to expectations that tariff rates would mirror those applied by other countries on US imports, the administration instead based them on the percentage by which a country's exports to the US exceeded its imports (see Figure 2). In essence, the president argued that any nation running a trade surplus with the US was, by definition, taking advantage of the relationship.

Figure 2

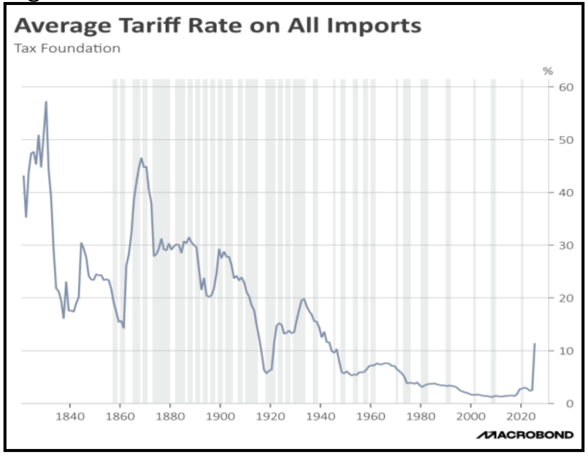
$$\underbrace{\Delta\tau_i}_{\textit{Tariff}} = \frac{\overbrace{\chi_i - m_i}^{\textit{Trade Deficit}}}{\underbrace{\cancel{\varepsilon * \varphi}}_{\textit{Elasticity}} * \underbrace{m_i}_{\textit{Imports}}}$$

The subtle but critical message behind this approach should not be underestimated. It signaled the start of a new trade era — one aimed at reshaping trade agreements so that the US no longer bears the disproportionate burden of global prosperity. Moreover, these tariffs marked a return to more restrictive trade policies, likely intended as a means to pressure other nations into negotiating more favorable terms.

Where It Started?

The last time the US pursued a ***restrictive*** trade policy was in the lead-up to World War II, during a period of strong isolationist sentiment. Policymakers, concerned that international entanglements were detracting from domestic priorities, sought to disengage from global affairs. This mindset culminated in the Smoot-Hawley Tariff Act of 1930, which dramatically increased import tariffs to shield American industries — especially agriculture and manufacturing — from foreign competition (see Figure 3).

Figure 3



After World War II, the US reversed course. A growing consensus held that protectionism had not only worsened the Great Depression but also contributed to the geopolitical tensions that had led to a second world war. Economists and policymakers argued that freer trade would foster interdependence, reducing nations' incentives for conflict. Moreover, the emerging Cold War with the Soviet Union added a strategic dimension. By opening its markets and promoting global trade, the US aimed to strengthen alliances, discourage countries from aligning with communism, and advance capitalism as the dominant economic model.

As a result, the US shifted to a ***reciprocal*** trade policy, actively negotiating tariff reductions and dismantling global trade barriers. This liberalization spurred significant economic expansion, particularly in Asia and Europe, as these regions gained greater access to the vast US consumer market. While this fueled export-driven growth abroad, it also exposed American manufacturers to heightened international competition and gradually reshaped the dynamics of domestic industry (see Figure 4, next page).

Figure 4

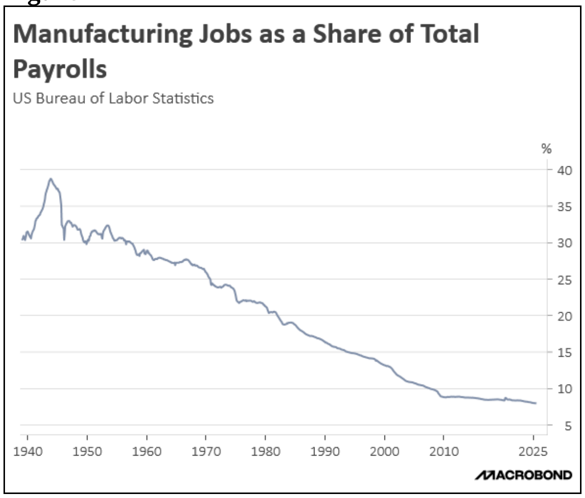
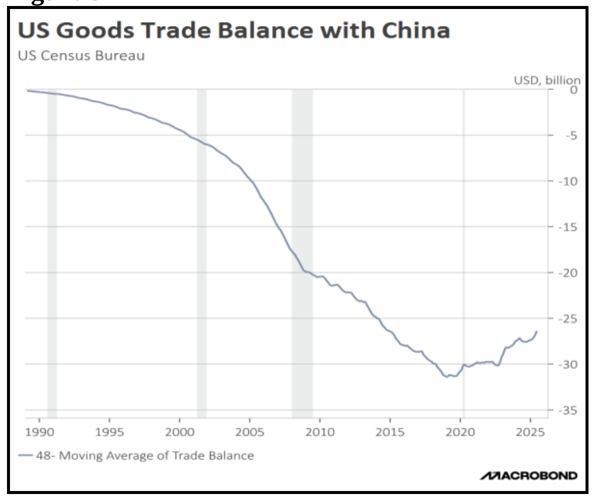


Figure 5



Peak Trade Enthusiasm

With the collapse of the Soviet Union and a diminished communist threat, US lawmakers found it increasingly difficult to justify reciprocal trade policies. Without a major geopolitical rival to serve as a rationale for dismantling trade barriers, opposition grew louder, with critics warning of the perceived dangers that free trade posed to the domestic manufacturing sector.

The outcry over China's trade relationship with the US reached a peak after China's entry into the World Trade Organization (WTO) in 2001. Congress had granted China Permanent Normal Trade Relations (PNTR), which made its “most favored nation” (MFN) status permanent and meant that China would receive the same low-tariff trade treatment as most other countries. Many in the US feared that China’s inclusion in the WTO and its new trade status would lead to a flood of cheap Chinese goods, making it incredibly difficult for American manufacturers to compete.

China’s entry proved to be the tipping point. The US had only a relatively small trade deficit when China entered the WTO in 2001, but the US deficit more than tripled during the next decade. In addition, there was a notable shift in the US economy. Labor received a smaller share of earnings, while capital actually saw its share increase. This widening imbalance led to a push by lawmakers to address the issue as a growing number of the population began voicing their frustrations.

In response to concerns about China's economic rise, the US pursued separate trade agreements with other economies, intentionally excluding China. These efforts included the Trans-Pacific Partnership (TPP) with Asian and Latin American nations, and the Transatlantic Trade and Investment Partnership (TTIP) with Europe. The goal of these agreements was to create reciprocal frameworks where member countries would reduce trade barriers, aim to establish more equitable trade relationships, and set a high standard for future global trade.

The TPP was successfully negotiated and signed by its member countries in 2016, but it was never ratified by the US Congress.

Meanwhile, negotiations for the TTIP were never finalized due to an inability to agree on a regulatory framework. The failure of both agreements marked the end of the reciprocal trade phase and a transition toward a more assertive trade policy.

The New Trade Phase

While it can be argued that President Trump's trade policies have incorporated all three Rs — ***reciprocal***, ***revenue***, and ***restrictive*** — it is clear that his administration is primarily focused on the latter two. The administration's main goal has been to use tariffs both to increase government revenue and to protect specific domestic industries from foreign competition. The administration approached these two objectives with different forms of tariffs.

For generating revenue, the administration has often used country-specific tariffs, particularly against China. These tariffs, which typically ranged from 10% to 20%, were designed to function as a tax on imported goods. The purpose is to generate income for the government, with the cost of these tariffs often being passed on to firms and exporters through the acceptance of lower profit margins and to American consumers through higher prices.

Figure 6

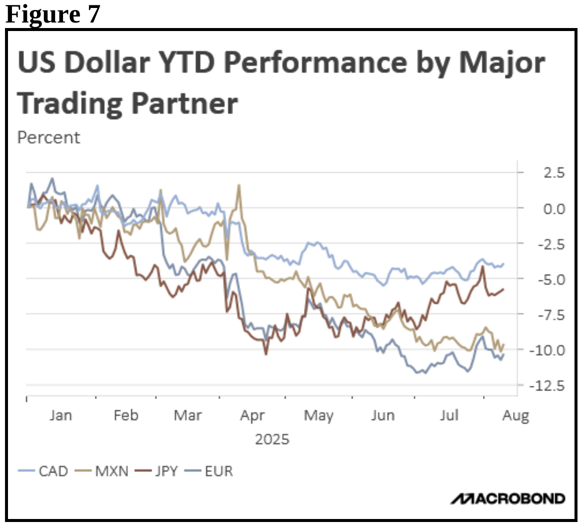
Country-Specific Tariffs		Sector-Specific Tariffs	
European Union	15%	Copper	50%
United Kingdom	10%	Aluminum	50%
Japan	15%	Pharmaceuticals	200%

However, the most restrictive tariffs tend to be sector-specific, with rates ranging from 50% to as high as 250%. These measures have primarily targeted industries such as steel, copper, and automobiles, key sectors where the administration aims to spur domestic investment and rebuild US industrial capacity. In the future, tariffs are expected to expand to include semiconductors and pharmaceuticals. The goal is to reduce foreign competition, allowing US industries to strengthen their competitive edge in the global market.

Ramifications

In a break from historical trends, it appears that the recent US tariffs have helped weaken the dollar. Unlike past measures, these restrictive trade policies limit other countries' ability to offset their impact through currency devaluation, whichdisrupts the traditional dynamic. Compounding this effect, the US retreat from reciprocal trade agreements has eroded foreign investor confidence in the dollar's supremacy as a safe haven asset. This dual pressure has triggered capital repatriation and accelerated the search for viable alternatives (see Figure 7).

Figure 7



The euro has emerged as a popular choice for investors, bolstered by recent stimulus measures and proposals for a joint EU bond. Concurrently, other countries are implementing policies to boost domestic spending, aiming to offset declining US exports with increased local demand, which further reduces interest in the US dollar.

Looking ahead, the full economic impact of these tariffs remains uncertain. While consumer price inflation in the US has ticked up, it is not clear if it will be short-lived or represent a more permanent structural change. Economic growth data is mixed as consumer spending shows some signs of decelerating but not enough to be alarming, and the labor market is slowing but not collapsing. Investment spending, with the exception of the technology sector, has been subdued due to policy uncertainty. We believe that greater clarity on trade policy will be the key to restoring business confidence.

For investors, a critical metric to watch is corporate earnings guidance. As long as firms can demonstrate a capacity to manage tariff-related costs without a long-term hit to profit margins, we remain optimistic about the US stock market's performance. The weakening of the dollar also makes foreign stocks an area of particular interest as they have historically outperformed domestic stocks in such an environment.

Thomas Wash
August 25, 2025

The Three Rs: Types of Tariffs

Source: *Clashing over Commerce*, by Douglas Irwin

	Reciprocal	Revenue	Restrictive
Primary Goal	Open foreign markets for domestic companies	Generate income for the government	Protect domestic industries from competition
Economic Impact on Trade	Promotes free trade and expands export opportunities	Moderately impacts trade; not primarily designed to restrict it	Restricts imports, can lead to trade wars, higher prices
Typical Tariff Structure	Lowest tariffs	Moderate tariff rates	Highest tariffs (Protective)