

What a First Week

That was quite a first week. In his first week in office, President Donald Trump withdrew the United States from the Paris Climate Accord and World Health Organization, threatened Canada, Mexico and Colombia with tariffs, initiated what were characterized as mass deportations of undocumented immigrants, criticized the Federal Reserve for its high interest rates, revoked a host of economic regulations promulgated by the Biden Administration and announced a \$500 billion artificial intelligence (AI) infrastructure plan. It was, to put it mildly, a lot for an economist, or for that matter anyone, to absorb.

Start with the tariffs, which are top of mind. The question is whether Trump sees tariffs as a combined negotiating tool and threat to extract concessions from other countries, or as a protectionist and revenue-raising measure to be imposed unilaterally. The Colombian episode, when Trump threatened Colombia with tariffs in response to President Gustavo Petro's refusal to accept U.S. military aircraft bearing deportees but then declined to follow through when Colombia backed down, is suggestive of the first interpretation. However, the fact that Trump has surrounded himself with true believers in tariffs points instead to the second. It may be that we will see a combination of the two strategies. Canada and Mexico may manage to get Trump to roll back the tariffs imposed on February 1 by taking steps on border security, while China, which is a strategic rival running a large trade surplus vis-à-vis the U.S., may be hit with significantly higher levies that stay in place for the duration. From this standpoint, it is interesting to contemplate the mixed prospects of the European Union, which is a geostrategic ally on the one hand, but runs a large bilateral surplus with the U.S. on the other.

Over Trump's first week in office, there was an almost perfect day-to-day correlation between the intensity of the president's pro-tariff rhetoric and the strength of the dollar. Investors evidently understand that the current account of the balance of payments is the difference between national saving and investment. Since tariffs, which have a first-order impact on neither saving nor investment, will switch U.S. spending away from now more expensive imported products, they will have to be offset by a stronger dollar, which pushes U.S. spending back in the other direction. This sets up an imminent conflict between Trump and the Fed, which the president will blame for the over-strong dollar. Trump's statement to the Davos World Economic Forum that he would "demand" lower interest rates is evidence that this conflict is looming. Financial markets will undoubtedly react badly to efforts to infringe on the independence of the Fed. The good news is that this may ultimately restrain the president. The bad news is that we are in for a period of financial turbulence.

Trump's deportations of undocumented immigrants, while still limited in number, are having their intended chilling effect. Farmers in California's central valley are already complaining of a shortage of field workers. Some economists predict a significant impact on food price inflation and, conceivably, Federal Reserve interest rate hikes in response. We are about to see an interesting, if socially regrettable, real-time test of the Mariel Boatlift hypothesis, in which Nobel Laureate David Card demonstrated that the mass immigration of Cubans to Miami in 1980 had a very limited impact on wages, inflation and the local labor market. If Card's conclusions carry over, then the economic impact of Trump's deportations may be less than their societal implications. We shall see.

Trump's suspension of funding provided under President Biden's Inflation Reduction Act and Infrastructure Investment and Jobs Act, designed to encourage investments in renew-

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able energy, and his elimination of the electric vehicle mandate, together with his executive order lifting restrictions on oil and gas exploration in Alaska, may be among his most consequential. By eliminating restrictions on the use of fossil fuels by American industry, they will widen still further the country's energy cost advantage over Europe. At the same time, they will make it even harder for a future U.S. administration to meet the Paris Climate goals, and for other governments, forced to pursue expensive measures shunned by the U.S., to proceed on their own. It has been suggested that Trump will also withdraw the U.S. from the umbrella agreement, the 1992 United Nations Framework Convention on Climate Change, making it more difficult for a future U.S. administration to reenter the Paris Accord.

The Inflation Reduction Act and Infrastructure Investment and Jobs Act were part of a broader Biden Administration industrial policy push designed to promote manufacturing. The Trump Administration and Republicans in Congress oppose these measures for the simple reason that they were Biden Administration initiatives, but also because their priority is cutting taxes. Having inherited a budget deficit north of 6% of GDP, they will have to find matching spending reductions, and it is increasingly unlikely that Elon Musk will find them elsewhere. However, they also understand that these pro-manufacturing policies benefit so-called Rust Belt states populated by Trump's constituents.

In theory, the Trump Administration could seek to substitute private funding for public funding, removing or relaxing restrictive regulations imposed on environmental, national security and other grounds. Thus, on his second day in office, Trump, appearing with Oracle's Larry Ellison, SoftBank's Masayoshi Son and OpenAI's Sam Altman, announced plans for a \$500 billion private joint venture, known as Stargate, to construct data centers and fund research and development on new AI applications. The irony, of course, was that no sooner was this joint venture announced than the Chinese company DeepSeek released an AI model that could match the capabilities of cutting-edge AI tools while using only a fraction of the specialized computer chips produced by Nvidia and its competitors, and requiring only a fraction of the training. It may be that the vision informing Stargate is already past its use-by date, and that those massive data centers are not needed after all.

Retaining one's sanity for the next four years will require keeping a sense of humor. I therefore close this Letter from America with Trump's cryptocurrency initiatives. On January 25, the president signed an executive order establishing a working group to provide regulatory clarity on crypto-related issues and to contemplate the "potential creation and maintenance of a national asset stockpile" or reserve. Confusion over whether this so-called strategic reserve would be comprised of Bitcoin or a broader portfolio of cryptocurrencies and whether it would consist solely of digital assets acquired by the federal government as a result of earlier legal and regulatory action or would include additional cryptocurrencies acquired by managers of the stockpile, set off frenzied speculation, grounded in exactly zero information. Even more amusing was when, coincident with the inauguration, Trump used his social media accounts to launch a meme-coin called \$TRUMP. Its issuance prompted an outraged reaction in cryptocurrency circles, where entrepreneurs and investors worried that Trump's value-free coin would discredit other "more respectable" digital assets, especially if it crashed.

But probably Trump's most significant action was his appointment of crypto-enthusiasts to head his Commerce Department and chair his Securities and Exchange Commission (SEC). One of the new SEC's first acts was to roll back accounting guidance limiting banks' involvement with crypto. Given the capacity of large, leveraged cryptocurrency positions to destabilize financial institutions and markets, maybe these initiatives are not so amusing after all.