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The costs of tariffs extend far beyond the targeted industries and countries

Import tariffs, once seen primarily as instruments for protecting domestic industries on the pretext of improving trade balances, are now being deployed to undercut geopolitical rivals and create strategic uncertainty.

Their novel uses even extend to coercing allies into yielding territory, with the Trump administration threatening eight European countries with additional tariffs in an attempt to gain control of Greenland – all under the banner of national economic security.

But much of the debate about tariffs, including Trump's Greenland threats, relies on outdated economic frameworks that overlook a defining feature of the modern global economy: deeply interconnected production and finance networks.

Thanks to these networks, tariffs can produce vastly different results than what traditional economic models would predict.

Rather than delivering limited and temporary distortions, they can generate persistent inflation, significant output losses, and powerful international spillovers, with tariff threat-related uncertainty spilling over to the financial realm – effects that can take quite some time to materialize.

The reason is simple: In today's economy, tariffs are not just a demand shock; they are also a supply shock.

While it is still true that tariffs shift demand toward domestically produced goods, domestic production now relies heavily on imported intermediate inputs.

From manufacturing components to energy, logistics, and business services, firms source inputs globally and depend on complex cross-border supply chains.

When tariffs raise the cost of imported inputs, they directly increase firms' marginal costs.

These higher costs then propagate across sectors and countries through production networks.

Industries that appear only indirectly exposed – such as services or downstream manufacturing – can experience substantial cost increases and price pressures.

As a result, tariffs distort not only what consumers buy, but also how firms produce.

As output contracts, productivity falls and inflationary pressures emerge well beyond the initially targeted sectors.

The economy can experience stagflation

Worse, this inflation may endure. In many sectors, firms change prices only infrequently, owing to pre-existing contracts, adjustment costs, or strategic considerations.

Such nominal rigidities mean that cost shocks do not translate into immediate price changes, but instead unfold gradually.

And in a multi-sector economy with input-output linkages, this gradual adjustment generates persistent effects, because past price changes continue to affect current inflation.

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Even after a tariff shock fades, its effects may linger as higher costs work their way through the production network.

This mechanism fundamentally alters the inflation-output trade-off that central banks face. Inflation rises not as a one-time jump, but as a prolonged process.

To contain it, monetary policy must remain tight for longer, amplifying output losses.

The economy can thus experience stagflation – rising inflation alongside falling output – even when tariffs are temporary.

Moreover, this outcome does not require extreme assumptions about import substitution (when a country replaces foreign goods with domestically produced ones).

Even if firms can eventually switch suppliers, complementarities in production networks ensure that the adjustment to temporary tariffs will be slow and costly.

Tariffs reshape global financial dynamics

Tariffs also reshape global financial dynamics. Typically, in economies with incomplete financial markets, exchange rates will respond not only to relative prices but also to wealth transfers induced by trade policy.

When a large economy imposes tariffs, its currency appreciates, reflecting a shift in global demand and a transfer of purchasing power toward the tariff-imposing country.

While the trade balance may improve initially, the exchange-rate appreciation implies sustained trade deficits over time.

> Uncertainty itself becomes a powerful transmission channel for trade policy, magnifying volatility in both goods and financial markets

Why, then, has the dollar depreciated since US President Donald Trump launched his global tariff war last April?

The answer is that the economic impact of tariffs is not limited to their implementation.

Announced but unimplemented tariffs can be equally disruptive, and the additional policy uncertainty can weaken the tariffing country's currency, as it has in the United States over the past year.

When firms and households expect future trade barriers, they adjust behavior immediately, front-loading imports, revaluing currencies, and revising consumption and investment plans.

If financial intermediaries demand additional precautionary savings and higher risk premia, the dollar depreciates even with small tariffs or tariffs that never happen.

These expectation-driven adjustments can generate deflationary pressures and output losses before any tariffs are imposed.

Thus, uncertainty itself becomes a powerful transmission channel for trade policy, magnifying volatility in both goods and financial markets.

Tariffs are not a localized policy tool

Given these dynamics, three lessons stand out. First, trade policy cannot be evaluated in isolation from production networks.

Models that ignore input-output linkages within global production networks and supply chains systematically underestimate output losses and fail to capture inflation persistence.

As governments reconsider the use of tariffs in pursuit of national economic security or geopolitical leverage, they should recognize that the costs extend far beyond the targeted industries and countries, creating risks for their own countries

Second, monetary policy plays a decisive role in shaping tariff outcomes. Passive monetary policy allows inflationary pressures to persist, while aggressive tightening deepens recessions.

Moreover, foreign central banks' responses matter as much as those of domestic ones in determining global outcomes.

Third, in a world of global value chains, tariffs are not a localized policy tool. They are a global macroeconomic shock, regardless of their purpose, with effects that spread across borders, sectors, and time through global networks and financial markets' expectations.

As governments reconsider the use of tariffs in pursuit of national economic security or geopolitical leverage, they should recognize that the costs extend far beyond the targeted industries and countries, creating risks for their own countries.

In today's networked economy, tariffs and tariff threats are not precise instruments with predictable effects.

They are a blunt, destabilizing force that can easily generate worldwide stagflation if introduced without regard to the underlying structure of global production.

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