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How to make Trump blink again

*Countries being hit by US tariffs should impose proportional retaliations across the board, without negotiations. America represents only 15 per cent of world trade and can be isolated. **Paul De Grauwe** writes that President Trump will blink when he feels that he and his billionaire friends are getting into trouble.*

We have learned a few lessons from the recent tariff upheavals initiated by President Trump. First lesson. The American economy is quite fragile. This fragility finds its origin in the strong link between the real economy (trade and production) and the financial markets. The fear of future deep troubles in trade and production quickly spilled over into the financial markets.

The central weakness of the American financial system is that large downturns in the stock markets can force unregulated and highly leveraged hedge funds (some with leverage ratios of 100) into a scramble for liquidity, leading to massive sales of assets, in particular of government bonds. This feature recently led to spikes in the yields of US government bonds reinforcing panic selling. Panic makes the American economy vulnerable, more so than other countries, because of the importance of unregulated financial markets.



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Second lesson. Behind the bombast and incompetence of Trump is a key weakness. When he feels that his billionaire friends and he himself are getting into trouble he will blink. The question for the other countries then becomes how to exploit these two weaknesses.

Certainly not by the representatives of seventy countries travelling to Washington hat in hand to obtain some special treatment from Trump. Not only do these trips show an abject absence of honour by the people undertaking them, but they also increase Trump's power. After all, if all countries go to Washington like beggars to obtain special favours, he will take advantage by playing them off against each other.

In addition, when confronted by beggars, Trump senses weakness to be exploited and adds more onerous conditions to any deal. And finally, Trump has a history of reneging deals he has solemnly signed. Why should countries sign a contract with someone who may turn his back on the document the next day?

The right approach, therefore, is to show strength and to exert maximum pressure on the American economy, which will then reveal its weaknesses, and on the billionaire friends of Trump, which will force him to blink.

This can be achieved, first, by stopping negotiations with the Trump administration, and second by imposing proportional retaliations across the board by as many countries as possible. Ultimately this will isolate America and America *can* be isolated: it represents only 15% of world trade. It should be possible by the countries representing 85 per cent of world trade to achieve this.

Some economists dispute the wisdom of retaliation. The standard argument of free traders is that import tariffs hurt the country that applies them, in this case the US. There is no reason why other countries should raise their import tariffs because the only thing they will achieve is to harm themselves. Let the US self-harm. Other countries should not be so foolish as to copy the US.

There is some merit in this argument. Import tariffs indeed imposes costs on the countries that apply them. However, the argument fails to consider the political economy of retaliatory import tariffs. By imposing them, countries harm the US export sector, thus giving rise to a lobby in the US that will try to stop or to reduce the US tariffs.

American exporters become a countervailing political force opposing Trump's tariffs. In the absence of such a force, only the lobby of the import substitution sector in the US is left supporting

these tariffs. Thus, by retaliating, the countries outside the US create an ally within the US opposing Trump's tariffs.

In fact, the political economy argument was used throughout the post-war period in the successive trade rounds, but in the other direction. In negotiating tariff reductions, countries used a reciprocity argument, i.e., they proposed to reduce their own tariffs in exchange for similar reductions by the other countries around the negotiating table.

In doing so, they created a domestic lobby of exporters favouring tariff reductions, helping break the opposition of a hostile import substitution sector. This approach was highly successful in leading to a worldwide process of tariff reductions.

There is no reason why the successful recipe should not be applied today. In this argument's logic, the EU and the UK should follow the Chinese example of across-the-board retaliations. This consists in imposing retaliatory tariffs on all imports from the US. In doing so, the pressure on the US exporting sector is maximised, increasing the probability of successful domestic opposition to Trump's trade policy.

Retaliation will also maximise the harm imposed on the US production and trading system. Through the link with the financial markets, it will expose the fragility of the American economy, forcing Trump to blink.

These countermeasures against the US should be taken as much as possible in the context of the World Trade Organisation (WTO). The WTO allows for retaliatory tariffs against a country that unilaterally increases tariffs. By acting in the framework of the WTO, countries outside the US send a signal that they want to maintain a rules-based system—the best guarantee for maintaining open trade relations. This approach also makes it clear that the US is the only major country that has placed itself outside the international trading system. The US becomes the lone exception, thereby also putting further political pressure on the Trump administration.

It will also be important for third countries to enter into new trade agreements among themselves or at least to maintain existing trade relations. There is a risk though that countries with large trade surpluses with the US (China, Vietnam, and other Asian countries) could try to dump their trade surpluses to the European Union and the UK, preventing the maintenance of stable trade relations among these countries.

The European Commission has already announced that it will respond by protectionist measures against China if that country dumps its trade surpluses on the EU-markets. The risk is that China in turn could respond by taking countermeasures. The trade war between the US and the rest of the world could then degenerate into a "Hobbesian" war of each country against each other. That is probably the biggest risk arising from the Trump shock.

This risk could be mitigated by the use of safeguard measures. These would allow for an import contingent in the EU free of tariffs. Above this contingent, tariffs would be applied. The European Commission has used this technique vis-à-vis China in the past. It is a technique that minimises the risk of retaliation from China.

While it is easy to formulate the general principles of why and how countermeasures should be applied, it is far more difficult to organise them. There is a collective action problem here. Few countries are willing to stick their necks out for fear of punishment. As a result, cooperation is difficult. But once all countries cooperate, the punishment the Trump administration can impose vanishes. Let's not forget that the US is responsible for only 15 per cent of world trade; the rest of the world for 85 per cent. The cost for the US to punish the whole world becomes prohibitive. When countries do not cooperate, however, they give a big stick to Trump to beat them.

To solve this collective action problem, we need leaders. China has already shown the way. If the EU were to join China, there would be two leaders big enough to harm the US significantly, thereby giving incentives to other countries (the UK, Japan, India, Brazil) to join the coalition. In doing so, they will further isolate the US, maximising the damage to that country (and its billionaires) and minimising the damage to the rest of the world. That must remain the objective of the governments of the world outside the US in their reaction. Then Trump will blink again, and his tariff policy will unravel.

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