(UBS)

How will Trump 2.0 tariffs affect the global economy?

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The election of Donald Trump to his first term as president in 2016 ushered in a new era of US trade policy defined by the threat and imposition of tariffs, sanctions, and other measures to try and rebalance America's trade deficits. The policies were also motivated by a view that tariffs would encourage production to move back to the US, reversing years of industrial decline, even if historically tariffs have not proven a successful tool to achieve these goals.

While the Biden administration that followed returned the US to a policy of multilateral engagement with allies, it also continued with President Trump's assertive approach towards China. The Biden administration retained tariffs implemented in 2018/19, hiked tariffs on a range of Chinese semiconductors and electric vehicles in 2024, implemented export controls, and scrutinized both inbound and outbound investment flows. With the benefit of bipartisan congressional support, the Biden administration also deepened its national industrial policy goals over the past four years to safeguard and promote US manufacturing, technology, and security interests through a range of legislation including the Inflation Reduction Act and the CHIPS and Science Act.

A more assertive second term

A second Trump administration promises a return to a more assertive, transactional, and isolationist approach to US trade policy. In our view, this will likely lead to a further ratcheting up of pressure on China. It is also likely to target other countries running large bilateral trade deficits with the US, deemed to be engaging in unfair trade practices, or shown to be facilitating the transshipment of goods to avoid tariffs. The new administration is also likely to focus its attention on sectors and products that are of high economic or national security importance.

How will tariffs affect the economy?
The growth and inflationary impact of tariffs has become a central theme for investors since election of President Trump and the Republican sweep of Congress. How tariffs impact both the US and global economies, especially inflation, will depend on how aggressively they are implemented (duration and magnitude) and the degree of retaliation. The impact of selective tariffs on US inflation and a targeted country's economic activity depend on whether trade is rerouted to avoid the tariff and the degree to which the US cracks down on countries that serve as way stations for avoiding tariffs. While bilateral trade between the US and partner countries may decline because of the tariffs, actual rebalancing of international trade or reshoring of economic activity back to the US would likely be negligible.

Universal tariffs, meanwhile, would likely be of greater harm to the US economy and create a short-term burst of inflation as importers pass along increased import costs to consumers. They could, however, lead to more significant onshoring of production. For the rest of the world, we expect US tariffs would harm economic activity as demand falls and could also prove deflationary as surpluses emerge in traded goods. The outlook for US inflation is clouded by the uncertain impact of tariffs on the final price of goods that consumers ultimately face.

On the one hand, (and contrary to misstatements in the press), a 20% tariff does not equate to a 20% increase in the final price of a product. A hypothetical imported pair of jeans that used to retail for USD 100 before a tariff is unlikely to cost USD 120 after a 20% tariff is imposed. Instead, we would estimate that a 20% tariff on a finished consumer good would translate to an average price increase of 8%, perhaps somewhat more.

Here's why. Recall that tariffs are applied at the dockside, not to the subsequent supply chain, which includes a wide range of warehouse, wholesale, retail, advertising, transport and other costs that factor into the final price. Econometric models that calculate the inflation impact will therefore assume a pass-through of just 40% of the tariff.

But equally, the final price could rise more than straightforward econometric models assume if tariffs open the door to expanded corporate margins and profit-led inflation. A 10-20% tariff applied to imported goods can create a powerful narrative to persuade customers to accept a higher price, and the potential for profit-led inflation would appear greater now than in 2018 (a year when margins were squeezed) because tariffs are more widespread and visible, and because US companies may believe that they have more pricing power now than in 2018.

Normally we think that the Fed would see tariffs as a one-time price increase like any other sales tax and would 'look through it' as it decides the appropriate policy rate. However, profit-led inflation would be more likely to trigger a reaction from the Fed in the form of tighter monetary policy.

An appreciation of the US dollar on either tighter expected Fed policy or safe-haven demand for US assets may not help to restrain inflation. In theory, a stronger US dollar shifts the cost of the tariff to foreign consumers (who must pay more for US imports), while offsetting the tariff for US consumers (who pay less in dollar terms for their imports, potentially offsetting the tariff). This is particularly the case with a universal tariff, where all imports are subject to the tax.

But while the 2018 tariffs were met with a depreciation of the Chinese yuan (RMB) against the US dollar (USD), this seems to have had little to no effect on import prices into the US. The US price of imports from China fell modestly, by 1.4% in 2019 (after the RMB weakened), but this was in line with the long-term trend in import prices for goods from China. China sells products like consumer electronics that tend to fall in price over time.

In short, the change in the dollar's value seems not to have affected the price of exports sold in the US. This also fits well with the fact that China (like nearly all exporters to the US) prices and invoices in USD. So, for at least the duration of the contract, a currency move should have no impact on the level of the import price to which the tariff is applied.

What the RMB depreciation did allow for was an increase in profit margins on exports to the US, which offset the negative volume effect coming from the tariff (there were of course negative margin effects on China's firms that depend on imports). The negative volume effect also took some time to kick in. US purchasers of imported goods (not necessarily retail consumers) had to pay the higher price of the tariff.

Overall, we would expect universal tariffs to have a noticeable, but somewhat fleeting effect, on consumer price inflation. In a September 2024 report on the economic and investment implications of higher tariffs, we estimated that a sustained 10% universal tariff applied across the board to US imports would raise overall price levels in the US economy by 1.3% for a year. The direct effect is a onetime price level change. (US goods imports represent 12.7% of GDP; a 10% rise in the price of these imports would therefore correspond to a 1.27% price rise.) If there is a profit-led price increase on top

of the tariff increase, then the rise in inflation will be greater. Even if profit-led inflation is confined to finished consumer goods only, we could see a US universal tariff of 10% raise the price levels by 1.7%.

For more, see the **Global risk radar: What could Trump 2.0 mean for global trade?**, published 19 November, 2024.

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