03 February 2025

Research Global

Trump fires first salvo in multifront trade war

- **Trump fired the first shot in a multifront trade war on Saturday when tariffs on Mexico, Canada and China became a reality.**
- **The tariffs are linked to border security and thus could be removed or reduced following negotiations. However, there is also a risk we see a tit-for-tat escalation in the short term. We also expect to see more tariffs on China later this year and that EU and possibly other countries will be hit as well before long.**
- **US growth may take a moderate short-term hit but fiscal easing keeps the medium term outlook broadly unchanged for now. Inflation will see a modest one-off impulse.**
- **The biggest impact for now may be the uncertainty the global economy is faced with, and supply chain planning for businesses have only become more tricky.**

What happened?

Donald Trump announced 25% tariffs covering all goods imports from Mexico and Canada, although energy imports from the latter will face only a 10% rate. In addition, Chinese tariff rates will be increased by 10%-points. The tariff changes will take effect from Tuesday 4th of February. While Trump had warned of the tariffs already in December, markets were not convinced and Polymarket only had a 25% probability of tariffs on Mexico and Canada before March. Hence, we saw a quite big market reaction with USD strengthening and US equity futures losing 3% from the peak on Friday.

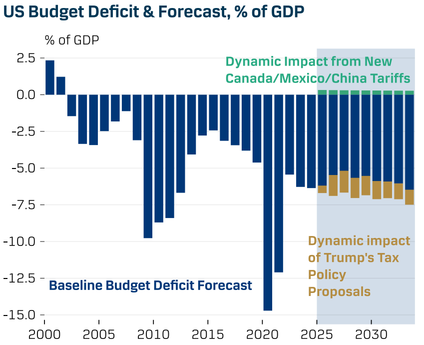
Canada has already announced 25% counter-tariffs on CAD155bn of imports from the US, which cover roughly 1/3 of the trade. Tariffs on goods worth CAD30bn will take effect on the same day as the US measures, while the rest will be enacted 21 days later. At the time of writing, Mexico has not yet announced counter-measures of its own, but *planning is reportedly under way*. China has stated it will take "necessary counter-measures" but without specifying details.

Impact on US economy to be moderate for now

On conventional basis, the new tariffs are expected to increase US public revenues by USD110-120bn per year according to *Tax Foundation*. This is equal to fiscal tightening of 0.3-0.4% of GDP, and excluding any impact from counter-measures, Tax Foundation estimates the negative impact on real GDP at 0.4%. Canada's counter-tariffs will add a further modest headwind to growth but note that while US accounts for nearly 75% of Canadian exports, Canada accounts for only around 16% of US exports.

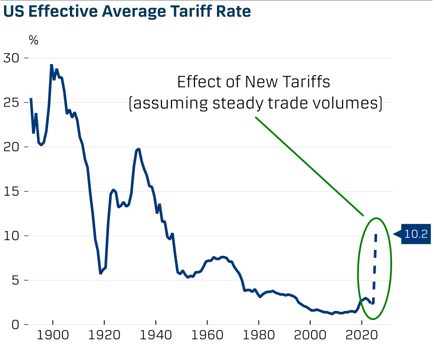
The fiscal tightening effect will most likely be counteracted by Republicans' planned easing to domestic taxation, even if we still know very little about its exact details. The *Penn-Wharton Budget Model* estimated earlier that Trump's campaign proposals could end up widening public deficits by more than USD600bn per year from 2027 onwards, with

Chart 1: Trump's easier domestic tax policies will likely counteract the tightening effect of tariffs announced so far



Sources: Macrobond Financial, Congressional Budget Office (CBO), Penn-Wharton Budget Model, Tax Foundation

Chart 2: The new tariffs will have a much more broad-based impact than Trump's 1st term measures



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majority of the increased spending coming from extensions to income tax cuts from the Tax Cuts and Jobs Act. We discussed the complicated interplay of funding domestic tax easing with import tariffs earlier in *Reading the Markets USD - How much of an impact will a fiscal hawk have?* 26 November.

Combining the two estimates with dynamic effects on growth and the Congressional Budget Office's (CBO) latest baseline budget forecast, 2025 deficit is still estimated to land at 6.4% of GDP – very close to 2024 levels. In other words, **overall fiscal policy stance remains expansionary**, and from 2026 onwards, deficits are set to continue widening (chart 1). US consumers might experience a negative 'shock' to their purchasing power in the near-term (3-9M horizon) but we do not think the tariffs announced so far have materially affected the medium-term macro outlook for the US (1-3y horizon).

The tariffs are significantly more broad-based than the measures implemented during Trump's first term. So far, China has been hit with the broadest measures, but *Fitch* has estimated that even they have covered only 60% of goods imports. If the measures are implemented without exceptions, the average effective tariff rate on all imports could. increase all the way to 10.2% (from 2.4%, chart 2) – the highest level since WW2. China, Mexico and Canada have made up around 45% of total US goods imports. In reality, lower trade volumes, some exceptions and re-routing of trade could moderate the impact on effective average tariff rate.

Goods imports make up around 9% of US private consumption according to *SF Fed*. This means the **theoretical direct impact on consumer prices would be only around 0.7%.** The depreciation of foreign currencies (CAD -8% vis-à-vis USD since early October, MXN -9.5%, CNY -3.3%) and importers absorbing part of the tariffs into their margins will moderate the impact on inflation even further. **We doubt the changes will derail the Fed, as *participants have flagged* they are willing to see through one-off increases in prices.**

More tariff shots to be fired

Trump has also threatened tariffs against the EU and said again yesterday it could come soon. Looking at changes in US trade balances since 2018, EU has been one of the economies with the largest widening in trade deficit (Chart 3). Countries such as South Korea and Vietnam, which have also seen sharply rising surpluses could also be in scope for higher tariffs. For markets and the economy in general, the most negative scenario would likely be the implementation of broad universal tariffs, which would apply to nearly all imports. The idea has been floated by Trump himself but also by the Treasury Secretary Scott Bessent (see *FT*). From the perspective of competitiveness of European exports though, universal tariffs might have a less negative impact than measures targeted at only EU specifically. The increased uncertainty adds a headwind to Europe, though, but while the trade wars may have come sooner than expected we have factored higher tariffs into our forecasts already. The negative effects will partly be compensated by more monetary policy easing by the ECB than otherwise might have been the case as well as currency depreciations vis-à-vis the USD.

Facing multiple trade wars is a bit of a nightmare from a supply chain management point of view. Many companies have invested in production and sourcing in Mexico as well as Vietnam but Trump's tariff crusade makes it difficult to predict where the next round of tariffs may hit.

Chart 3: The rising EU trade surplus with the US to trigger tariffs

US trade balance vs. EU

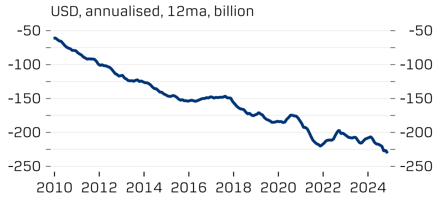

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Chart 4: South Korea...

US-South Korea trade balance

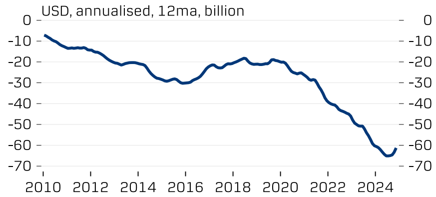

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Chart 5: ... and Vietnam also in scope for possible tariffs

US-Vietnam trade balance

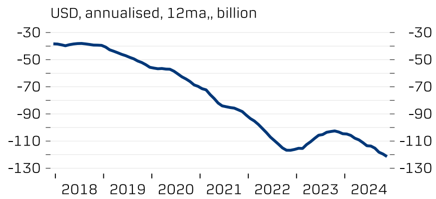

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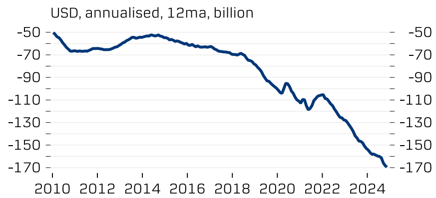
Chart 6: Mexico became the bridge to the US after trade war 1.0.

US-Mexico trade balance



Source: Macrobond Financial, US Census Bureau

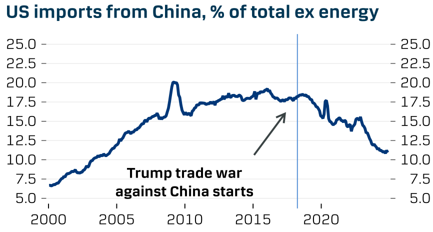
10% tariff on China is not the final shot

Trump's first tariff shot on China of 10% is purely *related to Fentanyl* and referred to as "leverage to ensure American's safety". It thus seems negotiable and could be removed if China clamps down harder on fentanyl trade. Also, a 10% tariff should be manageable for China, although of course a slight negative for growth. China's foreign ministry has said it will take "necessary countermeasures and bring the case for WTO, but they will likely be cautious not to trigger further tit-for-tat escalation.

However, more tariffs are likely to come at a later stage. As we outlined in *China Headlines – Tariff limbo, waiting for US trade study on 1 April*, 24 January, Trump in early January launched a number of *trade studies* that has a deadline on 1 April, which among other things is likely to conclude that China did not live up to the phase one trade deal made with Trump back in January 2020. It is also set to conclude China's is using unfair subsidies that justifies US putting up a higher tariff wall.

Our baseline scenario as we outlined in *Research China – a bumpy recovery in the making*, 4 December 2024, is that the average tariff rate will increase to 40% from now around 22-23% (after the 10% increase on Saturday). We expect rates to gradually be ratcheted up as part of a negotiation tactic but to ultimately stay permanently higher as China will struggle to meet US demand. As a consequence we shaved off ½% points of our GDP growth forecast from 5.2% to 4.7% for 2025. The impact is mitigated by an expected depreciation of the renminbi in reaction to the tariff towards 7.60 or USD/CNY. Since Thursday we already saw a sharp move higher in USD/CNH from 7.26 to 7.35 confirming that higher tariffs will drive a weaker renminbi and reduce some of the tariff impact, as was the case in the first trade war in 2018-19.

Chart 7: US imports from China reduced as trade rerouted to not least Mexico and Vietnam



Source: Macrobond Financial, US Census Bureau

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Report completed: 03 February 2025 at 15.00

Report disseminated: 03 February 2025 at 15:15 CET