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ASSET MANAGEMENT

FOCAL POINT

Risks to inflation and growth from US tariffs

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Our Focal Point series explores topical issues on macro, markets and investment.

- **As Trump becomes president, attention has rapidly focussed on the US tariffs rhetoric and the related risks. Our baseline scenario assumes a relatively mild and gradual increase in tariffs. This is a rather benign outlook, and the risks are tilted towards less favourable outcomes for the global economy.**
- **To quantify these risks, we have run two adverse scenarios based on what the new administration has indicated so far. Tariffs and retaliation would lead to a rapid deterioration in the global growth outlook, with a significant spike in US inflation. We then assume that from 2026 negotiations bring tariffs back down.**
- **We expect the Fed to initially raise rates to keep expectation anchored, but then to cut to cushion the impact of tariffs on growth.**
- **We expect the EU to respond in its own interest with a stick and carrot approach, and targeted measures like in the 2018 dispute are likely, in case of a mild US stance. But bolder responses with equal tariffs and use of alternative instruments (e.g. Anti-Coercion Instrument) are likely should tension escalate.**
- **In China, we expect a broader retaliation that will be of a different nature and will affect multiple sectors of the US economy. Tariffs hikes will be quick while we expect tightening of critical exports (rare earth) or pressure and lobbying on certain sectors (defence, technology, agriculture). The dump of the large pool of US Treasuries seems unlikely while we expect a control and more moderate CNY depreciation than in 2018-19.**

A new, harsher round of tariffs poses the biggest risk to the global economy from the new Trump administration. Soon after his inauguration President Trump reiterated the threat of tariffs, but so far, little is known about the shape and timing of these policies. However, legal, and political constraints, the pattern of US imports and the past Trump administration's transactional approach make bilateral tariffs, imposed after some negotiation with the main trading partner, more likely than global restrictions. This would result in a very gradual increase in tariffs, which would not have a significant economic impact until the end of 2026. This is our rather constructive baseline, which underpins our above-consensus US growth forecast for 2025. However, given the high degree of uncertainty surrounding trade policy decisions, and to provide an order of magnitude for the impact of higher tariffs on growth and inflation, we present two alternative scenarios based on the very limited information available on the new administration's intentions. We also summarise the measures that the European Union and China could take in response to trade restrictions.

Global tariffs: hard to legislate and not needed.

Under the US Constitution, primary authority over trade policy rests with Congress, not the President. The executive powers currently held by the White House derive from congressional delegation. They allow the president to impose tariffs only in certain circumstances, including national emergencies, threats to national security, unfair trade practices, selective discrimination against US exports, and balance of payments crises. Implementing a global tariff would require Congress to legislate on the structure of the tariff (including the rates). This process appears politically difficult, even with Republicans now controlling both houses. Import-dependent industries are likely to oppose generalised tariffs, which in turn could face resistance from manufacturers fearing retaliation. In addition, the experience of the previous Trump mandate shows a very uneven impact across states, a factor that could prove crucial given the narrow Republican majority in both houses. The challenge of reconciling potentially divergent interests means that the development of comprehensive tariff legislation would take months at best.

Ultimately, the need for a global tariff may be reconsidered. Bilateral trade data show that nine countries account for almost 80% of US imports and 96% of the trade deficit. Targeting some of these countries through bilateral action, which is allowed under the current delegation of executive power, would be both practical and beneficial in securing concessions from trading partners. For example, the Trump administration could impose tariffs on China for unfair trade practices, invoke a national emergency in the auto sector to confront Canada and Mexico, or designate the EU's stricter environmental and consumer protection rules as "unfair trade practices" requiring tariffs. It is worth noting that the US had a trade surplus with the UK in 2023, which has led to expectations that the country could be exempted. This is why we think the imposition of global tariff is rather unlikely but rather focus on country-specific tariffs in our scenarios.

Largest import sources (2023 data)

Partner	Import (US$ bn)	% total import	Trade balance (US$ bn)	% total balance
EU	577.1	18.7	-207.3	19.5
Mexico	475.6	15.4	-152.4	14.3
China	427.2	13.9	-279.4	26.2
Canada	421.1	13.7	-67.9	6.4
Japan	147.3	4.8	-71.2	6.7
S. Korea	116.2	3.8	-51.4	4.8
Vietnam	114.4	3.7	-104.6	9.8
Taiwan	87.8	2.8	-48.0	4.5
India	83.8	2.7	-43.7	4.1
Total	**2450.6**	**79.5**	**-1025.8**	**96.4**
UK	64.3	2.1	9.8	

Source: IMF DOTS, GenAM

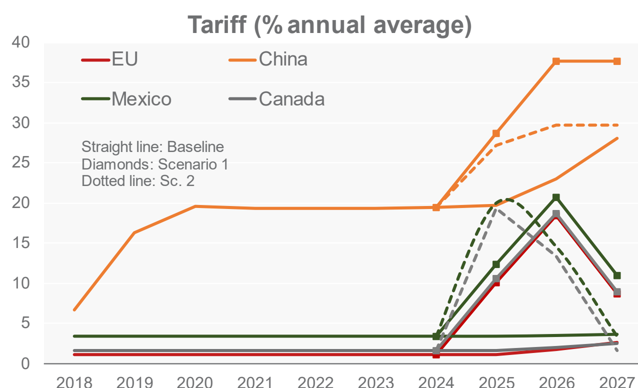
Tariffs scenarios and their macro impact

The large number of presidential orders signed just after inauguration did not entail trade directly, but President Trump was quick in reiterating threats of a sharp tariff rise tariffs against EU, China, Mexico, and Canada. We expect trade restrictions to be used more as a bargaining chip with traditional US allies and as an outright trade war instrument against China. To provide a rough guide of their quantitative impact We then develop two alternative scenarios based on the vaguely stated intentions known so far[1]:

1) Gradually raise tariffs on all countries with a significant trade surplus with the US by 2 percentage points per month until mid-2026, with partners retaliation only in part, raising tariffs by one half of what imposed by the US. Negotiations then begin with all partners except China, leading to a de-escalation that still leaves tariffs higher than in the baseline.

2) An early 25% tariff on Canada and Mexico and a 10-percentage point increase in tariffs on imports from China, with partial retaliation. Tariffs on Mexico and Canada are removed in Q2 2026 with the review of the US-Mexico-Canada Agreement.

Both scenarios would imply a sharp increase in tariffs, bringing US protectionism back to levels last seen in the 1960s.

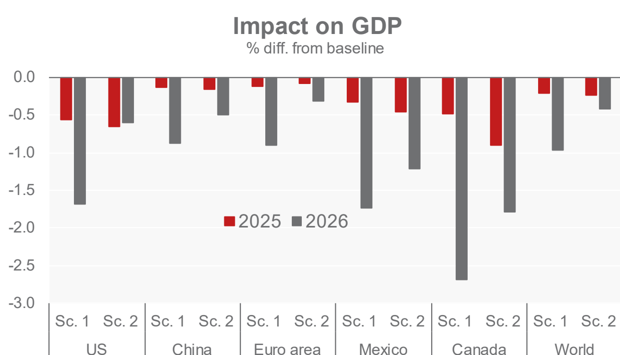


Source: Oxford Economics, GenAM

According to the model, the implementation of tariffs would quickly lead to a substantial GDP loss relative to our baseline. In both scenarios, tariffs and retaliation would trigger a mild GDP contraction in the second half of 2025, assuming that tariffs are used to finance the promised fiscal expansion plans, in line with what stated during the campaign. The closest trading partners would be hit hard, with activity losses of around 2% in the case of Mexico and Canada. China would be slightly less affected than the world average, as the marginal tariff increase is lower than for other countries/regions. In the first scenario, the euro area would

[1] We simulate the policy using the Oxford Economics Global Economic Model.

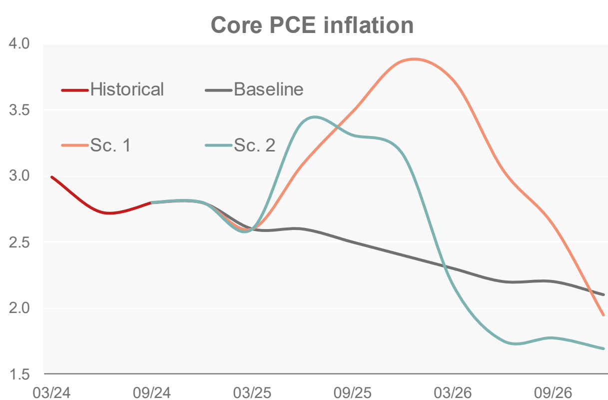
experience a slowdown in growth, even if it is not directly affected by tariffs. Within the region. Larger exporters such as Germany and, to a lesser extent, Italy would be hit harder than average.



Source: GenAM

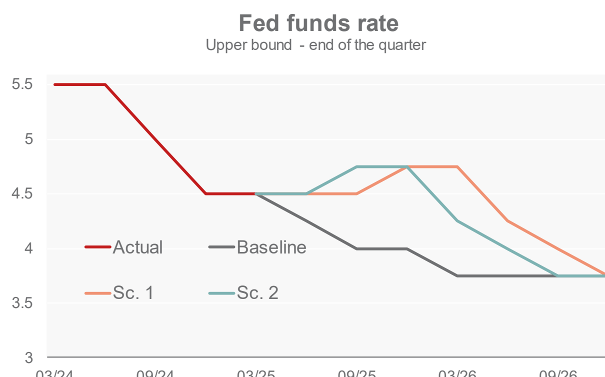
The inflationary impact would be much stronger in the US than elsewhere, as the limited export exposure of many countries to US exports would reduce the price impact of the retaliatory tariffs. Moreover, the slowdown in world activity would depress oil prices (-16% with respect to the baseline in the fir scenario in 2026) offsetting the tariff related increase in good export prices.

In the more adverse scenario, US core inflation would peak at 3.7%, i.e. more than one percentage point above baseline, by the beginning of 2026. This would be followed by a sharp downturn: tariffs are a shock to the price level, so their impact on inflation would gradually fade, secondly, the downturn in activity would dampen price increase.



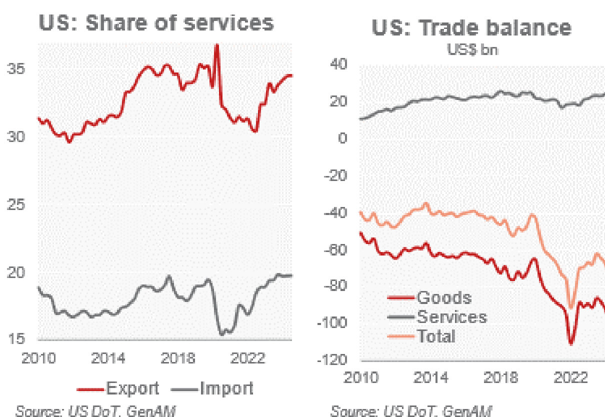
Source: BEA, GenAM

The stagflationary impact of a large and broad base tariff rise would put the Fed in a difficult position. In the background material for the September 2018 meeting the Fed staff developed a scenario featuring a rise in tariffs; model simulations shows that an approach in which monetary policy does not react to the inflation rise, but turns quickly more accommodative when growth declines, delivers an effective cushioning to output losses without any sizeable impact on inflation. However, the underlying assumption of anchored inflation expectations may be problematic, as tariffs would lead to sharp price increases in frequently used goods (apparel, cookware, etc.) and this is likely to affect inflation expectations. Therefore, we assume that, to stabilize expectations, the Fed initially raises rates as the inflationary impulse start materialise, before cutting aggressively to stave off the risks to growth.



Source: Federal Reserve Board, GenAM

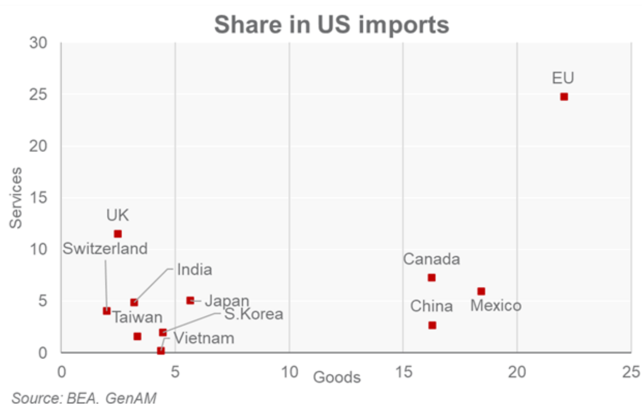
The Trump administration is seeking to target imports of manufactured goods to protect the US industrial base. Tariffs may succeed in reducing the trade deficit in goods, but at a potentially high cost to services, which have increasingly supported US exports since the GFC. Tariffs are ineffective in curbing overall external imbalances, as the latter depend largely on a country's net saving, which is largely unaffected by relative prices. Indeed, in our simulation, the high tariffs imposed in scenario 1 would at best reduce the US current account deficit as a share of GDP by around one tenth. Thus, a reduction in the goods deficit would be offset by a reduction in the services surplus. The appreciation of the USD would add to this trend by making US services less competitive globally.



Source: US DoT, GenAM *Source: US DoT, GenAM*

Higher tariffs on goods imports could then ultimately benefit countries with a strong presence in the US services market. The EU could partly offset the loss of goods exports, and relatively strong services exporters such as the UK, Switzerland and India could benefit on balance. Large goods

exporters with a low penetration of services, such as China, Vietnam, and Mexico, would be penalised.



Bold trade partners responses

In our scenarios we assumed that trade partners respond with restraint, preferring to hit economically and politically sensitive sectors rather that going go a full retaliation. Having a view on how this can be made, and which sector would be affected the most is key for investors.

EU: "stick and carrot" approach likely

A blueprint for how the European Commission could reply to when the US levied tariffs on steel and aluminium. The EU struck back at Trump in 2018 — just before the midterm election — targeting products made in the key U.S. battleground states. It lifted tariffs on Harley-Davidson motorcycles, Zippo lighters, Levi jeans and bourbon. We deem it likely that the European Commission plans something like exert economic pain ahead of the 2026 midterm elections.

However, the degree of tariff increase suggested by the incoming administration is much bigger and this increases the risk that the EC would take bolder retaliation measures. There are quite some instruments in the toolbox:

- Imposing tariffs on US products would be a straightforward reaction. Retaliation could take the form of a negative list meaning that the EU would increase its tariffs on all US exports to the same level as the US tariffs, except for products that are considered crucial for the EU.
- In contrast, the Anti-Coercion Instrument (ACI) is a much broader instrument and a kind of bazooka in trade instruments. It shall *"deter and respond to economic coercion, and thereby better defend its interests and those of its Member States on the global stage."* The Commission sees it as a last resort and include restrictions on the access to the EU market and other economic disadvantages for the third country involved. The list of options is broad, and covers areas such as trade in goods, services, foreign direct investment, financial markets, public procurement, trade-related aspects of intellectual property rights, export controls, and more. An advantage of this instrument is that doesn't automatically put-up countermeasures but first starts with *"cooperative engagement*" between the two parties.
- Apart from these two instruments more specific tools exist. The EU could make the life of US exporters harder by imposing additional technical barriers to trade.
- Also, it could respond through the International Procurement Instrument. If the investigation finds that restrictive measures like the local content in products exist, this instrument gives leeway to limiting the access of businesses, goods or services originating in non-EU countries to the EU public procurement or concession markets.
- Lastly, EU could also target dumping or subsidies lavished on producers in the exporting country. It uses this instrument already when targeting China's electric vehicle subsidies**.** Anti-dumping measures can be put on imports of specific products and usually take the form of an 'ad valorem' duty. Other measures that can be applied include a fixed or specific amount of duty or, in some cases, a minimum import price.

At the same time, it will likely increase its efforts to moderate the US appetite for tariffs by exploring ways to increase purchases of US goods. Right after the US election EC President von der Leyen for instance suggested to buy more US LNG in order to substitute the still significant amount of fuel the EU buys from Russia. Also, the EC will likely try to make the trade topic part of a greater bargain by committing itself to substantially higher military spending, in which US companies have a clear competitive advantage.

Given the fragility of the EU's current economic situation and its dependence on US energy imports, we think that the EC will opt for a smart solution consisting of increased tariffs in areas that are not critical. To nevertheless retaliate with an economically equivalent measures to the US import tariffs we deem it likely that it makes also use of the ACI which offers the possibility to target other areas than goods, for instance services, where the US held a surplus of € 104 bn in 2023 (versus a €160 bn deficit in goods). It also leaves the way open for a negotiation process and might thereby help to avoid a further escalation in the trade dispute. In any case, we think that the EU will bring the topic to the WTO, as it did in the previous dispute, and try to preserve the rule-based international trade order. To do so it could EU build a coalition

among key players from the Global North as well as Global South and expand its network of trade agreements.

China: more non-tariffs retaliation than in 2018

When discussing the new US administration's policies and tariff-related threats to China, the retaliation aspect of Chinese policy is less discussed, although the potential consequences can be large and thus indirectly influence the final US administration's decisions.

During the first Trump presidency, Chinese retaliation was mostly focused on tariffs with a tit-for-tat approach as China increased its trade-weighted tariff rate on US goods by 13.8% to 21.8%. This time around, if the level of tariffs being touted is applied, we expect a broader retaliation that will be of a different nature and will affect multiple sectors of the US economy. Indeed, the US will put more pressure as the tariffs are expected to be higher but also broader in scope. For example, it will be harder for Chinese companies to avoid tariffs by transhipping through Vietnam or Malaysia as the US Commerce Department has recently taken a tougher approach, for instance on solar panels exports from South-Asian countries.

First, on tariffs, China has strengthened its tariff laws to provide a legal basis for raising tariffs on countries that remove Most Favoured Nation. So, it will act quickly, if necessary, but may be more constrained than during the first Trump presidency, as it may still be dependent on certain US supplies and economic activity is weaker. However, if Trump turns hawkish, US energy, agriculture and chemicals export could see new tariff hikes, as was the case in 2017. They may also target sectors that are easily substitutable for China, such as soft commodities, or stop imports from US states where it matters.

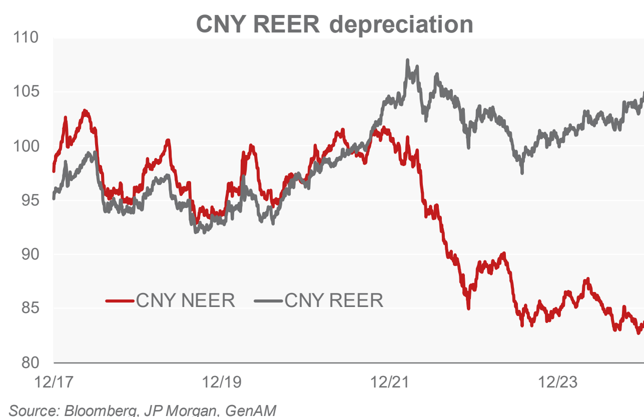
Second, non-tariff retaliation could be much more significant and target specific export sectors:

- China could tighten its import controls on critical materials such as rare earths, which are crucial for green projects and on which the semiconductor supply chain relies heavily.
- Similarly, it could tighten exports of military equipment such as drones and other dual-use products, with a list to be published in late 2024. It has also launched a list of unreliable entities, to which it added seven new US companies banned for selling arms to Taiwan earlier this week.
- It can ban public procurement of certain technology products from the US in the name of national security.
- However, it seems unlikely that China will directly penalise US companies such as Tesla or Apple. It may put pressure on them, lobby them a bit, but the attitude of foreign investors towards China is already uncomfortable, and that will ultimately affect FDI.

Third, we do not expect China to use the threat of a sell of the US Treasuries stockpile as it is unlikely to be very effective as the Fed can step in via emergency facilities. Moreover, it is hard to find a suitable alternative to the US Treasuries

Fourth, we do not expect the policymakers to use the FX threat. For sure, the broad-based tariffs will weaken the CNY but it is against China's will. If we apply a similar devaluation as in 2018/2019, USD/CNY would go to 9.00. This seems unlikely as the CNY was coming out of a significant period of appreciation then, while the CNY has been depreciating for almost three years now. Moreover, it is not in China's interest to trigger a sharp CNY depreciation, given the ongoing deflationary pressures. It could also trigger financial instability and further damage confidence and capital outflows. Finally, in REER terms, the CNY has depreciated close to 16-year lows, supporting export competitiveness, and thus reducing the need for a managed depreciation in response to tariff hikes.

Beyond all these retaliations measures, even if China retaliates with a range of different measures, it remains that none of the options are likely to hurt the US economy as much as US policy can hurt the Chinese economy.



Source: Bloomberg, JP Morgan, GenAM

Conclusion

We seek to provide an order of magnitude of the economic consequences of the tariff plans the incoming administration has sketched. A lot of the details are missing, what the simulation shows is that risk to create harm to growth, endangering the streak of very good US GDP performance, reducing the strength of its services sector, and aggravating the difficult situation in China. For Europe growth could be dampened by up to one percentage point relative to baseline. Especially the already weak German economy would face additional headwinds triggering a recessionary period and keeping euro area output growth well below potential. With inflation lastingly falling or being in danger of doing so below

the 2% threshold, the ECB would cut rates well into expansionary territory again.

We also show that the rest of the world is not powerless in the face of US potential protectionism, and we believe that this bargaining power will ultimately lead to a negotiation solution leading to a delayed and moderate rise in tariffs, which underpins our rather bullish US growth forecast for 2025.

Imprint

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