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Markets in a Minute

Guy Foster, Chief Strategist, discusses the latest U.S. trade tariff developments and their potential impact on European economies. Plus, Janet Mui, Head of Market Analysis, analyses fresh U.S. inflation data.

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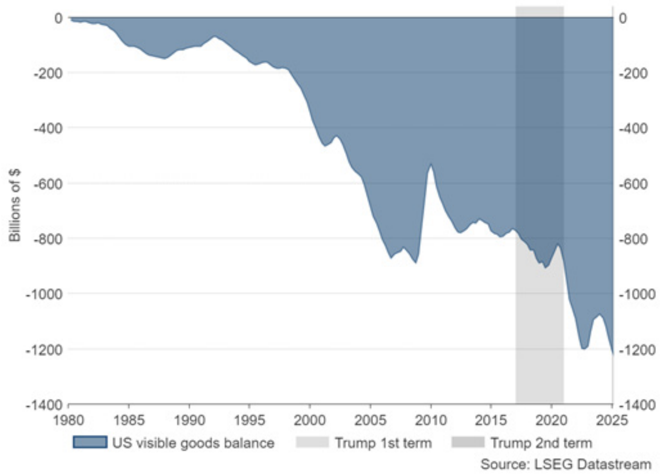

"Tariff is a beautiful word. It's a great word. It's a word I like."

Donald Trump, U.S. President

President Trump loves tariffs. Not just that, but in a contrast to standard economic understanding, he described trade wars as *"good"* and *"easy to win"*.

When he first took power in 2017, the U.S. visible goods deficit was about $770bn per annum. When he left office, it was $880bn, an increase of 3.4% per annum over the duration of his first term (most of which would have related to inflation). At the end of 2024, the deficit had risen to $1.2tn.

Understanding tariff economics

Back in 2016, when the suggestion of rolling back decades of progress in reducing tariffs began to be taken seriously, economists pointed out that their research found few long-term links between tariffs and trade balances. It seems implausible that raising the price of an imported good wouldn't lead to a drop in demand for that good, and indeed, that's typically the case in the short term. However, this trend doesn't hold over the long term. Why?

Economics is complex and sometimes struggles to conform to scientific analysis. We can't perform experiments or have control samples on economies and so conclusions should be viewed with scepticism. That complexity means that when you change one thing, many other things may change as a result.

In the case of tariffs, the most obvious resulting change is a retaliatory tariff. There's also a reaction in the currency market. If Americans buy fewer imported goods because of tariffs, they use less foreign currency, which can make the U.S. dollar stronger. That stronger dollar makes imports cheaper and exports more expensive. The tariff might apply to a particular good, but the exchange rate adjustment applies to all goods. So, you would expect to see an improvement in the balance on the tariffed good but a smaller deterioration in the balance on all other goods.

What's the point of tariffs?

The point of the tariff might be to encourage consumers to switch suppliers. They may do so, but not necessarily to a domestic supplier.

Another reason might be to persuade the supplier to relocate its manufacturing. Again, it may do so, but not necessarily to within the U.S.

Since the U.S. imposed tariffs on Chinese imports, America's bilateral trade deficit with China has improved. However, America's overall trade deficit hasn't improved because non-Chinese imports have taken the place of Chinese imports. Perhaps this is the reason that President Trump had been discussing imposing tariffs on all imports. That would limit the ability of consumers and suppliers to switch to other non-U.S. jurisdictions to avoid the tariff.

However, it's still unlikely to be beneficial.

America has a low rate of unemployment. It arguably has very little spare capacity. And so, for Americans to displace the activities of importers, they would likely need to stop doing other things.

Under free trade, America's educated and largely skilled workforce produces higher value goods and services than those it imports. So, the effect of the tariffs would be expected to be inflationary, but not necessarily productive. Indeed, since many imports are components that end up in exported products, there's widespread belief the tariffs would lead to increased prices and reduced growth.

Recent data seemed to support the notion that the U.S. labour force is currently highly employed. The working age labour force participation rate is relatively high, and inflation has remained persistent.

In last week's Consumer Price Index (CPI) report, most measures of inflation showed some persistence, which makes cutting interest rates very difficult. Federal Reserve Chairman Jay Powell seemed to endorse this message in his testimony to Congress.

EU and UK at risk due to high VAT rates

Last week, President Trump seemingly shifted his stance from imposing universal tariffs on all imports to focus on reciprocal tariffs — those imposed in response to tariffs from other countries on U.S. goods. Most of these countries are emerging markets with higher average tariffs on U.S. imports.

However, last week's memorandum from President Trump specified that he believes that value added tax (VAT) is effectively a trade restriction.

In many countries that have a VAT, imports from the U.S. would be subject to it, while exports to the U.S. would receive a VAT refund. Despite studies indicating that VAT doesn't impact trade balances, President Trump and his adviser Peter Navarro don't subscribe to conventional economic analysis. The Secretary of Commerce has now been tasked with reviewing the effects of tariffs and VAT rates on U.S. trade in order to develop recommendations for U.S. import tariffs by 1 April.

Without knowing exactly how they'll reach their judgements, it seems likely the EU and UK could appear to be imposing some of the highest tax rates on imports from the U.S. (should they be evaluated by those standards). This is the case despite the UK having a relatively balanced trade relationship with the U.S.

Research indicates that tariffs don't cause lasting adjustments in trade deficits, which are more influenced by differences in competitiveness. The U.S. has a trade deficit because its wages are much higher than those in other regions, making production more costly.

While tariffs may encourage more domestic manufacturing, this could also lead to less affordable products due to higher production costs. The U.S. already receives significant investment from abroad, which effectively mirrors the trade deficit it runs. However, as President Trump encourages further investment, he inflates the U.S. dollar and makes its exports less competitive.

Trimming the fat

There are some actions being taken by the U.S. administration that may help curtail the deficit.

If Elon Musk's initiatives at the Department of Government Efficiency are successful, they could reduce U.S. government borrowing. The trade deficit reflects America's ability to spend beyond its means and reducing borrowing is key to closing this gap. The typical times when this happens is during recessions, when you normally see an improvement in America's balance of trade.

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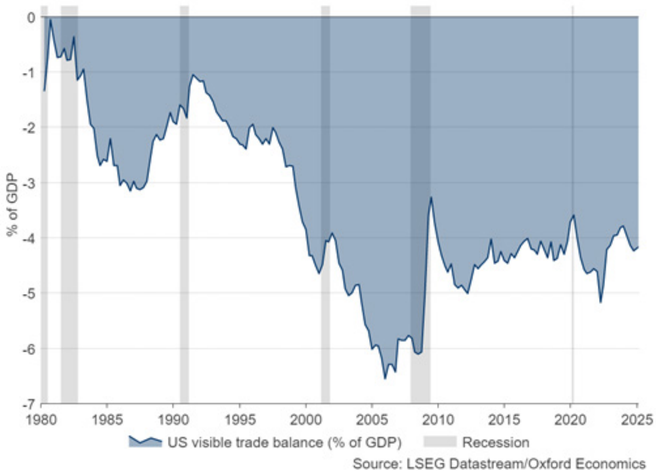

There are things other regions could do as well...

They could improve their own investment appeal. If, by doing so, they were able to divert some U.S. investment into say, Europe or the UK, that would help to restore some of America's export competitiveness.

Fundamentally, there are ways to improve the U.S. trade deficit, yet most of them would be associated with lower domestic demand and higher investment in trade partners. This doesn't really seem aligned with the administration's goals, and it seems unlikely they'd be particularly popular.

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