State of Play

Trade tariffs: shields or shackles

28 November 2024

In our previous State of Play we discussed the market reaction since it was announced that Donald Trump and the Republican Party had won the race for the presidential election. This week, the President-elect has suggested that he would impose massive tariffs on China, Canada and Mexico when he takes office in January, an announcement that left the markets in fear of a new trade war with Beijing. This week's State of Play looks at the importance of exports and imports on local and global economies and the potential impact increased tariffs could have.

Exports and imports

Exports contribute directly to a country's economic growth by driving domestic production and creating jobs. High levels of exports usually indicates that a country has a high level of industrial output and often leads to an inflow of foreign currency, which can stabilise local economies. For example, manufacturing exports from Germany and technology exports from South Korea have helped establish these nations as economic powerhouses.[1]

Imports, on the other hand, provide access to goods and resources that may not be available or economically viable to produce domestically. For example, countries like Japan rely on energy imports to sustain their industries. Importing advanced machinery or technology can also enhance a country's productivity by improving its infrastructure and industrial capacity.

The balance between imports and exports is reflected in a country's trade balance. A trade surplus (more exports than imports) boosts economic growth, while a trade deficit might indicate an economy's reliance on foreign goods. However, deficits are not always harmful if they accompany a robust economy and are tied to the import of productive assets like machinery.

Global impacts

Globally, trade facilitates specialisation, allowing countries to focus on producing goods and services where they hold a comparative advantage. This interconnected system reduces costs, increases efficiency, and raises global standards of living. For instance, the globalisation of supply chains in sectors like electronics and automotive manufacturing has significantly reduced production costs and enhanced innovation.

International trade also drives economic interdependence, fostering diplomatic ties between countries. However, it can create vulnerabilities; disruptions in one country, such as a supply chain crisis, can have ripple effects worldwide, as evidenced by recent global semiconductor shortages.

What are trade tariffs?

An import tariff – sometimes called an import duty – is a tax on a good or service that is imported into a country. It's collected by the government of the country importing the product.

How exactly does that work in practice?
Imagine the UK decided to impose a 10% tariff on all bicycles imported from Germany.

If a UK consumer or a business wanted to import an £800 bicycle from Germany, they would have to pay the UK government £80 when it entered the country.

So, everything else being equal, the final price a consumer in the UK would end up paying for this bicycle is £880. If a local industry or another country without the tariff could produce competing goods at a similar price, it would have a cost advantage.

What are the effects of tariffs?

Tariffs primarily have two notable impacts.
They provide a source of revenue for governments and many nations have implemented tariff systems for this very purpose. Since borders and ports naturally facilitate the tracking and regulation of goods entering and leaving a country, they are convenient locations for collecting and enforcing these taxes.

Tariffs also increase the cost of purchasing goods made in other countries. This higher cost tends to discourage imports and promote alternatives, such as buying from domestic producers. This approach ties into the concept of 'protectionism,' which aims to shield local workers and industries from international competition. By making imports more expensive, tariffs are intended to drive consumers toward locally produced goods and services, thereby boosting demand for domestic labour and supporting the growth of national industries.

The challenges

While tariffs may benefit workers in industries competing with imports – potentially increasing their employment opportunities and wages – they also create drawbacks, including higher prices for consumers. In response to tariffs, foreign producers might lower their prices to remain competitive, but this can only offset some of the impact. Ultimately, a portion of the tariff cost is often passed on to consumers.

Shifting to domestic producers is rarely straightforward and typically comes at a higher cost. Before the tariff was in place, consumers likely chose foreign goods because they offered better prices or quality. Tariffs can also force some foreign producers out of the market entirely, as selling becomes less profitable. This reduces the range of products available to consumers. Additionally, with fewer competitors, domestic businesses may seize the opportunity to raise their prices further, compounding the impact on consumers.

Trump's views

President-elect Donald Trump has suggested that he would impose massive tariffs on China, Canada and Mexico when he takes office in January, an announcement that left the markets in fear of a new trade war with Beijing. The threatened double-digit tariffs would likely have major impacts on key sectors of the US economy, including car manufacturing, crude oil and agriculture, all of which involve trade with the targeted countries. The announcement sparked a dollar rally. It rose 1% against the Canadian dollar and 2% against the Mexican peso, while share markets in Asia and Europe fell.[2]

Our views

We estimate that a blanket 10% tariff on all US imports – which would take US tariffs back to the levels last seen in the 1960s – would raise US consumer price inflation by 1.1%. If, as threatened by the president-elect, Chinese goods are subject to a higher tariff of 30%, then inflation could be more than 1.4% higher by the end of next year than if tariffs had never been introduced. Moreover, any such unilateral action could well provoke a set of tit-for-tat tariffs, potentially leading to a full-blown trade war that would be very negative for global growth. Even the threat of a sharp rise in tariffs is likely to deter corporate investment and keep central banks from cutting interest rates more sharply than they otherwise would have.

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions and risk comfort. If you already have a plan in place or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing here.

Note: data as at 28 November 2024

[1]Investopedia, 26 November 2024
[2]Reuters, 26 November 2024