



The return of tariffs

July 15, 2019

The ups and downs of trade talks have analysts sharpening their pencils and reassessing the impact of trade policy on growth and inflation.

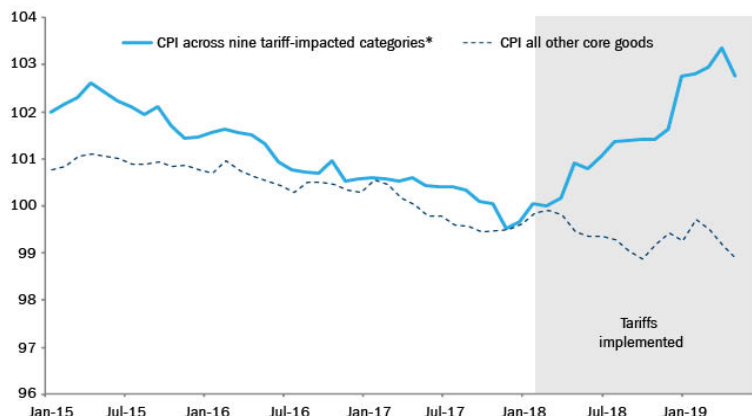
In late May, trade talks between the U.S. and China ended abruptly. The U.S. raised the tariff rate on \$200 billion of imports from China from 10% to 25% and raised the prospect of additional 25% tariffs on remaining imports of about \$300 billion. In addition to China, there remains a risk of Section 232 auto tariffs on imports from Europe and Japan. And most recently, trade policy risks were ratcheted up a notch with the threat of tariffs used as an economic weapon in discussions over immigration policy with Mexico.

With the passage of time, it's now possible to assess the impact of the tariffs already in place. New academic studies have used data on import volumes, U.S. import prices, U.S. producer prices, and U.S. consumer prices to conclude that:

1. The costs of the tariffs have fallen mostly on U.S. businesses and households. Contrary to expectations that Chinese exporters might lower prices to stay competitive, detailed analysis of import prices (before tariffs) reveals no decline in prices of imported goods that faced tariffs;
2. Domestic U.S. producers of tariffed goods (not affiliated with a Chinese parent company) have opportunistically raised their prices in response to tariffs on Chinese goods.

► Impact of tariffs on Consumer Price Index

Index (Feb 2018 = 100)



*Includes laundry equipment and other appliances, furniture, bedding, floor coverings, auto parts, motorcycles, sport vehicles, housekeeping supplies, and sewing equipment and materials. Weighted by CPI relative importance.

Source: Goldman Sachs, used with permission.



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If the trade war continues and all the new tariffs under discussion are implemented, the likely immediate effect would be higher inflation. Estimates among economists vary, but many are projecting it to be in the range of 0.5% to 0.9%. This would be a temporary, one-time increase in prices.

A bigger concern is the effect these distortions would have on growth.

- Economic theory tells us that higher prices reduce real purchasing power while lowering demand for goods and services. Depending on consumers' ability to substitute tariffed goods, this impact may or may not be consequential, ranging from 0.1% to 0.5%.
- The indirect effects of tariffs are harder to estimate. An atmosphere of increased uncertainty damages business sentiment, reducing companies' propensity to plan for projects and make capital investments. We've already seen a decline in business sentiment since the recent escalation of trade tensions, and breaks in supply chains are likely to impose significant costs on U.S. manufacturers.

Another indirect effect of tariffs is a deterioration in market sentiment and increasing anxiety around the escalation of tariffs. As of late June, stock markets were performing quite well but have shown increased volatility as the market analysis of trade war expansion shifts from week to week. Deterioration in market sentiment and tightening financial conditions are additional channels that could have a negative indirect effect on growth.

Bottom line

The Federal Reserve acknowledges the risks to growth from tariffs. Against a backdrop of slowing global growth, with a renewed threat of escalating tariff wars, the Fed is likely to stay accommodative for a longer period of time. A stagflationary environment (i.e., a temporary rise in inflation and hit to growth) would raise the odds of Fed rate cuts.

ADVISOR RESOURCES:

Download a more detailed discussion on [tariffs](#).

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The screenshot shows a presentation slide titled "Overview" with the Columbia Threadneedle logo. The slide is divided into sections: "Review and outlook", "Macroeconomic", "Global equity", "Global fixed income", and "Multi-asset". The "REVIEW" section states: "After 2018, when all asset classes had negative or minimal returns, more dovish comments from the U.S. Fed fueled all asset classes in Q1 2019, delivering positive returns. U.S. stocks led equities, and high yield and emerging markets led fixed income in Q1 2019. U.S. stock market volatility returned to normal levels in Q1 2019 after spiking in Q4 2018 to near-record-high levels." The "OUTLOOK" section includes: "Economic growth: Global economic growth is expected to slow down in 2019, although a recession is not likely."; "Interest rates: Central banks have paused normalizing monetary policy and raising rates, which is partly supply reflected in bond yields."; "Inflation: Inflation is expected to have peaked in 2018 and then decline modestly along with slowing GDP growth."; and "Valuation: Equity valuations are above historical averages." A footer at the bottom reads: "© 2019 Columbia Management Investment Advisers, LLC. All rights reserved. Topic: Columbia Threadneedle Investments." and a page number "3" is visible.



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