U.S. and China Exchanging Tariff Blows – Round 3

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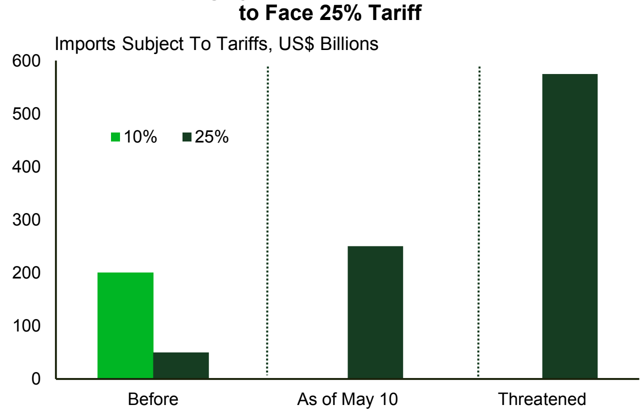
- At midnight or thereafter, the U.S. administration may follow through with its threat to increase its tariff rate on US$200bn in imports from China to 25%, from the 10% rate that had been in place since last September (Chart 1). In Table 1, we show GDP impact estimates for the U.S., China, Canada, and the global aggregate should this occur. Incorporated in these estimates is Chinese retaliation. Given the bilateral trade imbalance, retaliation would likely take the form of tariff increases beyond the 10% already in place on $110bn in U.S. goods, as well as currency depreciation, business subsidies, and steps to impede U.S. business operations in China. The data presented are meant only as guideposts to potential economic impacts, as there are numerous interacting forecasts at play. The extent of market sentiment deterioration and the length of period it is sustained are critical wildcards to these estimates.
- The economic impacts presented are driven by three key channels: **Direct**, reflecting estimated substitution effects and supply chain disruptions; **Income effect**, which is the impact of rising prices on consumer and businesses, sapping purchasing power; **Confidence and wealth effects,** which reflect increased economic and trade policy uncertainty. This dents business and consumer confidence, feeding risk-off sentiment in global equity markets, and ultimately weighing on business investment growth.
  - Of the three channels, the confidence effect is the major one for Canada and other countries not directly involved in the trade dispute. The income effect is the biggest driver of the estimated U.S. and China impacts.
- Past TD Economics research suggests that there is only a small scope for Canada to benefit from substitution of U.S. or Chinese demand due largely to capacity constraints and product mismatch.
- The estimates in Table 1 largely reflect the effects of higher prices and deteriorating confidence and stock market wealth.
  - For the U.S., we estimate that the tariffs imposed thus far have boosted headline inflation to the tune of 0.3ppts. That said, tariffs on 25% on the remaining $325bn in imports from China (so far only threatened) could boost consumer price inflation by an additional 0.4ppts, hitting consumer goods that had mostly been exempted from past tariffs.
- All forecasts and impact analyses are subject to a high degree of uncertainty, particularly as it relates to confidence and wealth (stock market) impacts. Pass-through of tariffs will depend on sector-specific price sensitivities (elasticities) which can result in the price burden falling on Chinese producers, or U.S. consumers, and are likely to vary by specific products and the availability of substitutes.

Chart 1: Roughly Half of U.S. Imports From China to Face 25% Tariff

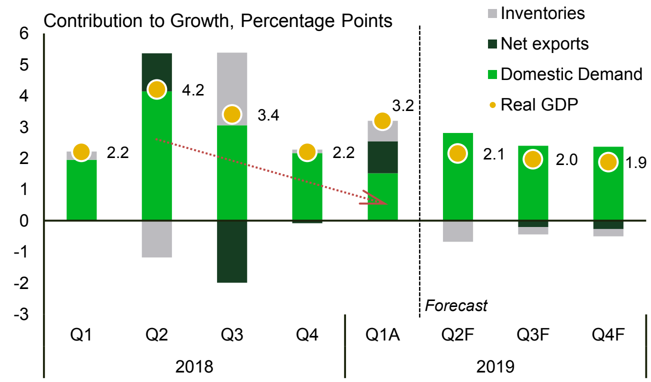


Source: U.S. Government, TD Economics.

- Our estimates assume that the worst of the confidence impacts are front-loaded, peaking over the summer months. Should the U.S. and China restore confidence in short order (i.e. within a month or so), the economic impact should be transitory, particularly if that confidence is restored by a firm trade deal that offers greater export opportunities for the U.S.

- A word of caution is needed on global activity. There is a real risk that this time may not look like the last time on tariff escalation.
  - The growth cushion globally has been reduced significantly this year. Economic growth has decelerated to below-trend for many advanced economies, particularly relative to the past two years when they were expanding at an above-trend pace. While the U.S. economy maintains a growth advantage, it too has seen a steady slowdown in domestic demand and has lost the stimulus impulse to businesses from prior corporate tax cuts (Chart 2; Note that our current forecast excluding tariff escalation is shown).
  - This is evidenced by the deterioration in forward-looking indicators captured by the ISM indexes, which appear to be converging with those of other advanced economies despite the domestic growth advantage. The global economy was in the very early stages of producing green shoots through market stabilization and a restoration of production and shipments. However, the expansion stands on shaky legs and its resilience is likewise of greater concern should confidence impacts not prove short lived.

Chart 2: U.S. Domestic Demand Slowing Beneath Quarterly GDP Volatility



Source: Bureau of Economic Analysis, TD Economics.

Table 1: Level Impact on GDP 12-Months Ahead (%)				
	U.S.	China	Canada	Global
Increase Tariff to 25% (from 10%) on US$200bn in Imports from China	-0.14 [-0.1 to -0.3]	-0.12 [-0.1 to -0.2]	-0.12 [-0.1 to -0.2]	-0.05 [-0.04 to -0.1]
25% Tariff on US$325bn in additional Imports from China	-0.28 [-0.2 to -0.6]	-0.2 [-0.15 to -0.3]	-0.14 [-0.1 to -0.3]	-0.1 [-0.06 to -0.2]

Note: Range of estimated impacts in parentheses. Lower end of range assumes lower confidence and stock market impact, while upper end of range assumes much stronger confidence and stock market effects.

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