How likely is a global trade war?

March 23, 2018

The Trump Administration's recent announcements of tariffs on steel, aluminum, and an array of consumer goods from China have sparked a frenzy of concern over the risk of a global trade war. How will these tariffs affect the U.S. economy? How concerned should investors be about the likelihood of a global trade war?

Vanguard expects minimal direct economic impact from the new tariffs. We feel their real importance lies in the broader and longer-term implications for U.S. trade policy.

Putting the tariffs in context

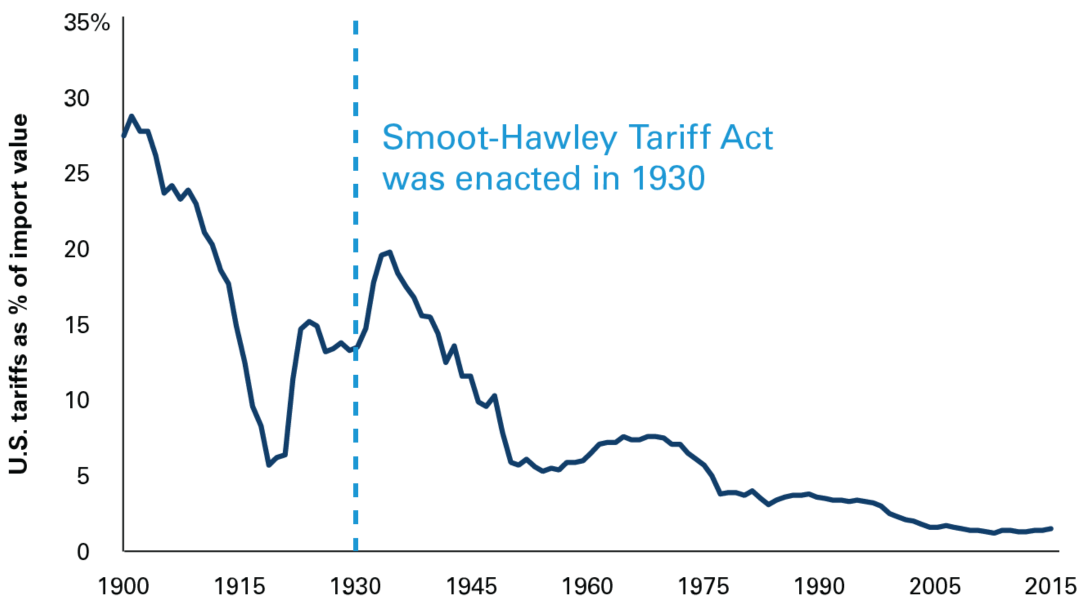
The Trump Administration first announced it was imposing tariffs of 25% on steel and 10% on aluminum—products that together represent less than 2% of total U.S. imports. And even that estimate is high, because Canada, Mexico, and other allies, including the European Union, have been temporarily exempted.

On March 22, the administration announced a package of tariffs and trade penalties on goods from China. As with the tariffs on steel and aluminum, these taxes would likely affect only a small fraction of bilateral trade between the world's two largest economies.

To better understand what escalation of these disputes might look like, it's helpful to consider trade in a historical and global context.

U.S. ranks low in protectionism

U.S. tariffs have been falling since the 1930s and have been below 5% for more than four decades, as the accompanying figure shows. According to the World Trade Organization's latest report on tariffs, the current average U.S. tariff is 3.5%, the second-lowest in the G-20.



Note: Data shown are annual from 1900 to 2015.
Source: U.S. International Trade Commission.

Although the United States has in place nontariff trade measures such as antidumping and national-security safeguards, it remains one of the world's least protectionist countries, alongside the members of the European Union.

Some market observers extrapolate the policy tilt of the tariffs to mark the onset of a trade war, similar to the vicious cycle sparked by the infamous Smoot-Hawley Tariff Act in 1930, which dramatically reduced trade flows and economic growth in the early years of the Great Depression.

Given the history of lowering trade barriers and realizing the benefits of economic integration, we believe it is unlikely that the current administration will dramatically shift trade policy at the risk of disrupting domestic growth.

Benefits of a slight rise in tariffs fast diminish

Although we assign a trade war scenario a low probability, our analysis in an earlier Global Macro Matters paper titled "Trade status: It's complicated" estimated the impact of varying escalations in trade tensions. A slight increase in tariffs has a short-term marginal benefit to the U.S. economy in the absence of retaliation. These benefits quickly diminish, however, and can be offset by retaliatory tariffs and market volatility.

With tariff increases offsetting one another, the end result would be higher consumer prices and lower growth from reduced trade activity—a lose-lose scenario.

Although less than a 10% likelihood, we estimated that this trade-war environment could reduce GDP by 1.7 percentage points and increase inflation by 0.4 percentage point annually. In this case, the impact would be significant enough to force the Federal Reserve to pause its tightening cycle and choose between suppressing excessive inflation and bolstering low growth.

Tariff fallout could put U.S. in lagging position

Outside these estimates of the direct impact on the U.S. economy, reduced cooperation on trade over the next few years could hurt cross-border investment flows and place the United States in a lagging rather than a leading position in future economic and political partnerships.

Investors can reasonably assume that trade rhetoric will remain a source of volatility throughout 2018 as the administration tries to set a new course on trade policy without triggering retaliation from partners.

Although a trade war is still a low likelihood, it is worthwhile to closely monitor U.S. policy decisions and the responses of trading partners for signs of escalation.

Notes:

- All investing is subject to risk, including possible loss of principal.
- Investments in stocks or bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk.

ETFs
Mutual funds
Benchmarks
Tax center
My product list

Portfolio Analytics
Find Similar

Client Relationship Center
ETF Knowledge Center
Literature & forms
CE credits

Economy & markets
Portfolio construction
ETFs
Wealth management
