Special Report

BMO Capital Markets
We're here to help.™

A timely analysis of economic issues May 10, 2019

Tariff-ic

Sal Guatieri, Senior Economist • sal.guatieri@bmo.com • 416-359-5295

Just when the clouds were parting for the U.S. economy in light of perkier productivity and equity markets, the threat of rising **trade protectionism** struck like a lightning bolt this week. After months of what seemed like constructive talks, the President said China *"broke the deal"*. Although talks continue, hopes of a quick settlement were dashed, and new 25% tariffs kicked in. So, after an eight-month ceasefire, it's time to sharpen our pencils again and tally the economic casualties from the trade war.

Let's start with the U.S. To be sure, estimates of tariff effects on GDP are fraught with uncertainty due to the many moving parts. To simplify the analysis, **we exclude currency effects**—the dollar is up 6% against the renminbi in the past year, allaying the loss of spending power though aggravating the effect of retaliatory actions on exports. We also **ignore policy responses** designed to cushion the blow—for instance, China has eased monetary and fiscal policies since the tariff tiff began last summer. **We focus on three channels**: the **loss of purchasing power** from higher-priced imports (with companies running at full tilt, imports will need to come from other countries or still from China, in both cases at higher cost); **China's retaliatory actions** to punish U.S. exporters; and, an **assumed adverse effect on business confidence and supply chains** that dampens investment. With that understood, the previous tariffs—25% on $50 billion of China's goods effective July 6, 2018 and 10% on almost 6,000 items valued at $200 billion effective September 24—are estimated to reduce U.S. GDP by about 0.2% over roughly a year. Friday's ratcheting of the latter duty to 25% and expected counter measures by China could hive off another 0.1%. And, if the President carries through with a repeated threat to impose a 25% duty on all other goods imports from China (about $270 billion based on the 12-month tally to March), then another 0.3% will be added to the roster.

So, the total cost to the U.S. economy of the current trade tiff and threatened escalation with China could amount to 0.6%. Adding earlier tariffs on global imports of metals, solar panels and washing machines slices another 0.1%, while the looming threat of a duty on automobiles (excluding Canada and Mexico) could reduce activity by an additional 0.3% (we'll know next week as the President is expected to make an announcement by May 18).This implies around **1.0% of lost U.S. output (or 1½ million jobs) due to past and threatened protectionist actions**. No small potatoes.

China will suffer more than the U.S. While U.S. sales to China account for less than 1% of U.S. GDP, China's shipments to the U.S. make up over 3% of its economy. The earlier tariffs likely lower China's GDP by 0.5%, and the recent higher duty could strip off another 0.4%. The combined 0.9% impact could then nearly double to **1.7% if all of China's shipments to the U.S. are hit with a 25% tax**.

Bystander Canada gets off lighter than China and the U.S. but not unscathed. Watching your major trading partner and world's two largest commodity consumers slug it out on the battlefield doesn't exactly inspire confidence among businesses (though you wouldn't know if from the latest jobs report). The estimated 1.0% slowing in U.S. GDP due to current duties and possible further protectionist moves could translate into 0.5%

less Canadian output, based on the estimated impact of a change in U.S. growth on Canada. Lower commodity prices won't help. Including earlier tariffs on steel, aluminum and retaliatory actions could cost the economy another 0.3%, putting the potential **hit from a global trade war at around 0.8%** (or 150,000 jobs) for Canada.

Apart from some firms in protected industries, there are few winners when countries start unfurling the protectionist banner. While the U.S. may extract concessions from China that eventually support its trade balance and economy, the casualties on the ground are starting to mount. It's a high-stakes game for both nations, which is at least one reason to believe that either side will fold and call a truce.