ECONOSIGHTS

with Diana Mousina

DECEMBER 2024

The Basics of Tariffs

Key points

- Tariffs increase the price of imported consumer items, protect domestic production and increase government revenue.
- History shows that higher tariffs lead to lower trade growth, which weighs on global GDP growth. The uncertainty created with trade disputes also tends to be negative for sharemarkets.
- There are never any clear "winners" in trade disputes. The uncertainty of Trump 2.0 tariffs are likely to cause volatility and downside for sharemarkets but the trade disputes are unlikely to disappear in the short-term because they will be used as a negotiating method for US "maximum pressure" in dealing with issues around US border security, the global AI battle and unfair trade practices.

Introduction

In this edition of *Econosights* we look at the basics of tariffs to help us understand the impact of Trump 2.0 tariffs.

How tariffs work

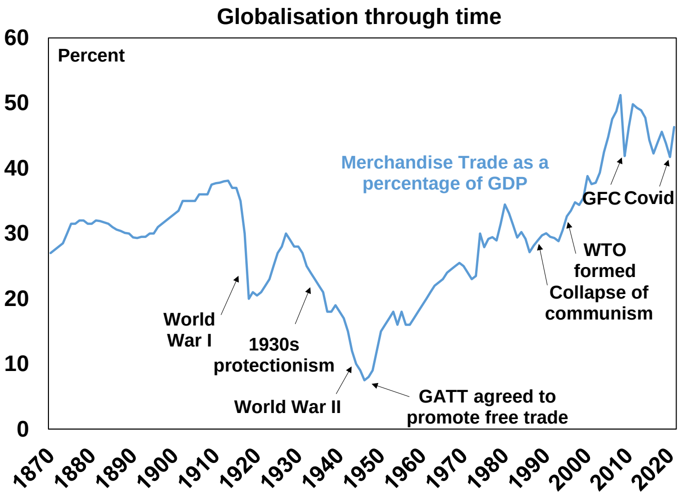
A tariff is a tax that a country implements on its imported goods. The mechanics of tariffs are: imported items increase in price, the importer passes the increase in price down the supply chain either completely or in part (therefore absorbing the cost increase) with consumer prices usually increasing. The increase in price for consumers is meant to reduce the demand for this item, and consumers may substitute this foreign-made good for a domestically produced item, reducing reliance on imports.

The purpose of tariffs can be to protect "infant" industries as they grow or to punish another country for what it deems to be "unfair" trade practices (like dumping cheap goods onto the market or theft of intellectual property). In the process of imposing tariffs, the government also receives additional revenue which can be used to fund government spending or reduce the budget deficit (if there is one).

In reality, the start of one tariff often leads other countries to retaliate by imposing their own tariffs, then causing a global trade "war" which disrupts the normal flow of goods and services and dampens economic growth. At the end of the day, the consumer loses because of higher prices, the domestic producer benefits from being able to supply more and the government benefits from additional revenue. However, in the long-term tariffs distort the market and end up being an inefficient tax.

The history of trade

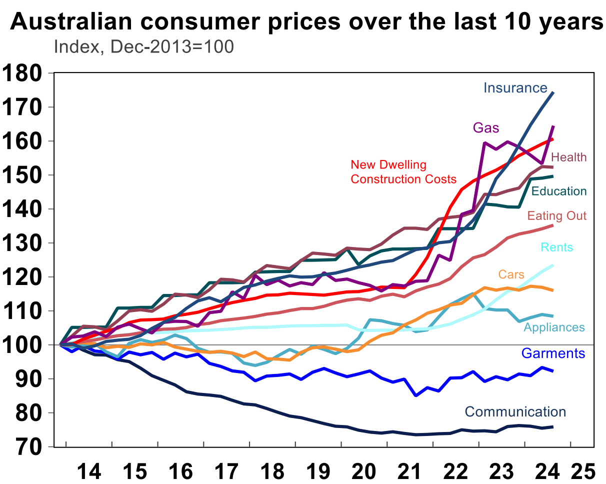
Globalisation led to a surge in global trade over the last 70 years. This is seen by the increasing share of merchandise trade growth around the world.



Source: BCA, World Bank, AMP

The "protectionist" period of the 1930s (with the US imposing the Smoot-Hawley Tariff Rate) saw trade growth slowing and bottoming in World War II. The General Agreement on Tariffs and Trade signed in 1947 which was aimed to promote free trade led to merchandise trade rising from sub 10% of global GDP to a peak of 51% of GDP, helped along by the World Trade Organisation (WTO) forming in 1995 and China joining the WTO in 2001. Globalisation shifted production of goods to countries that had a comparative advantage to produce those goods, which saw manufacturing flow out of advanced Western countries to South-East Asia. This led to a backlash of advanced countries lamenting the loss of their domestic manufacturing facilities and jobs, which has been a contributing factor to the rise in populist parties across the Western world over the last decade.

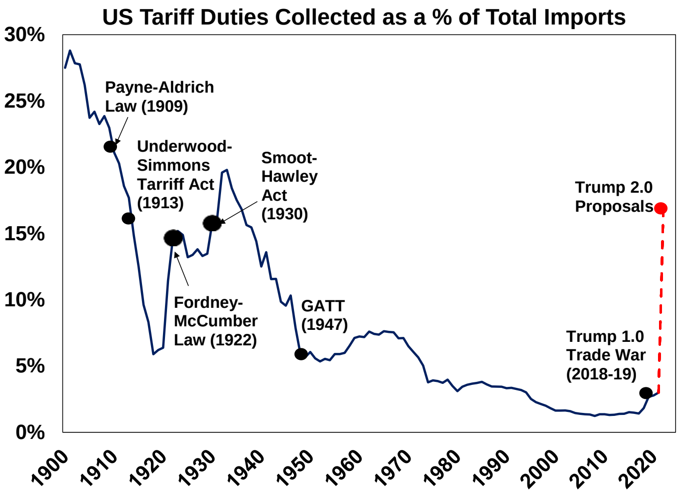
Consumer goods prices have had lower inflation in the past decade compared to most services (see the chart below), one sign of how the average consumer has benefitted from globalisation.



Source: Macrobond, AMP

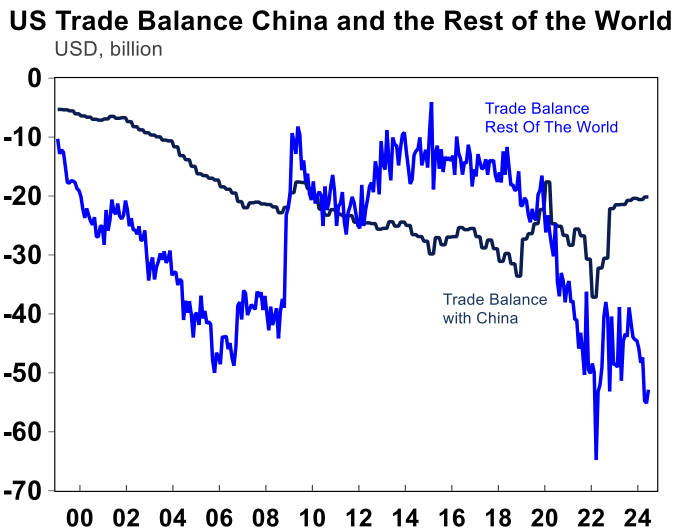
Garments have fallen in price over the last decade, appliance prices have gone up by just 8% and car prices are up 16% over the 10 years – well below the price of most services.

Trade disputes between countries has an extensive history and a lot of trade disputes are long-lasting. The most significant ones recently include The First and Second Opium War between Britain and China in the 1840s, the US Smoot-Hawley Tariff Act in 1930 done to "protect" US farmers and businesses (partly a result of the Great Depression), the "Chicken Wars" between the US and European countries in the 1960s, the US/Japan automobile trade war in the 1980s, the "Pasta War" between the US and Europe in the mid 1980s, the "banana wars" between the US and Eurozone in the late 1990s and the US/China Trade war in 2018. These cases have not seen a clear "winner" and issues tend to be negotiated, although most often this takes a long time. So, the reality of trade wars tends to be different to US President Trump's comments that "trade wars are good and easy to win". The 2018 US trade war with China lead to a 1 percentage point increase in the average US tariff rate from ~1.5% prior to 2018 to 2.7% and has remained at just under 3% as the Biden administration kept most of the Trump tariffs and expanded some recently. Trump's proposed tariff increases if fully implemented would take the average US tariff rate to ~17% - its highest level since the 1930s.



Source: Evercore, AMP

After the 2018 trade war, the deficit between the US and China narrowed (see the chart below) but the trade deficit expanded with the rest of the world, which indicates that the US just shifted spending from China to other countries which defeats the purpose of going into the trade dispute, although the pandemic does complicate the analysis.



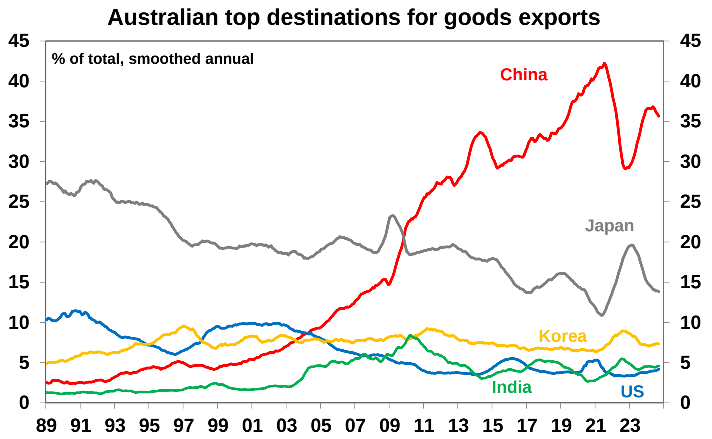
Source: Macrobond, AMP

Another consequence of the trade war has been China changing its trade routes, to avoid directly exporting to the US, with countries like Vietnam and India benefiting from this change in trade routes (see the chart below). Exports to the US accounted for 19% of China's exports in 2018 and has fallen to sub 15% most recently.

Source: Macrobond, AMP

Australia and the US

The US is Australia's 5th largest export market, taking up 4% of exports, with the largest areas being food, machinery and transport and critical minerals.



Source: ABS, AMP

Australia and the US have a free trade agreement and this means that most exports are tariff free. The US also runs a trade surplus with Australia (i.e. it exports to Australia more than it imports from Australia). However, specific items that Australia exports to the US may still be targeted with tariffs (Howard Lutnick in Trump's administration has previously mentioned Australia's Lithium exports). Australia's export growth (especially commodities) may also get weakened by a slowing in global trade growth (especially in China) from the tariff disruption.

Implications for investors

We have previously written about the likely trade impacts of Trump 2.0 (here and here). The bottom line is that trade wars are unpredictable and tend to be messy. The US sharemarket fell by ~19% peak to trough in 2018,, during the time of the Trump 1.0 trade war (although other things were occurring as well like rising US interest rates). Either way in this context, investors need to be prepared for more sharemarket volatility in 2025, especially in US markets and it's difficult to see sharemarkets (especially in the US) continuing to have significant outperformance like there was in 2024.

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