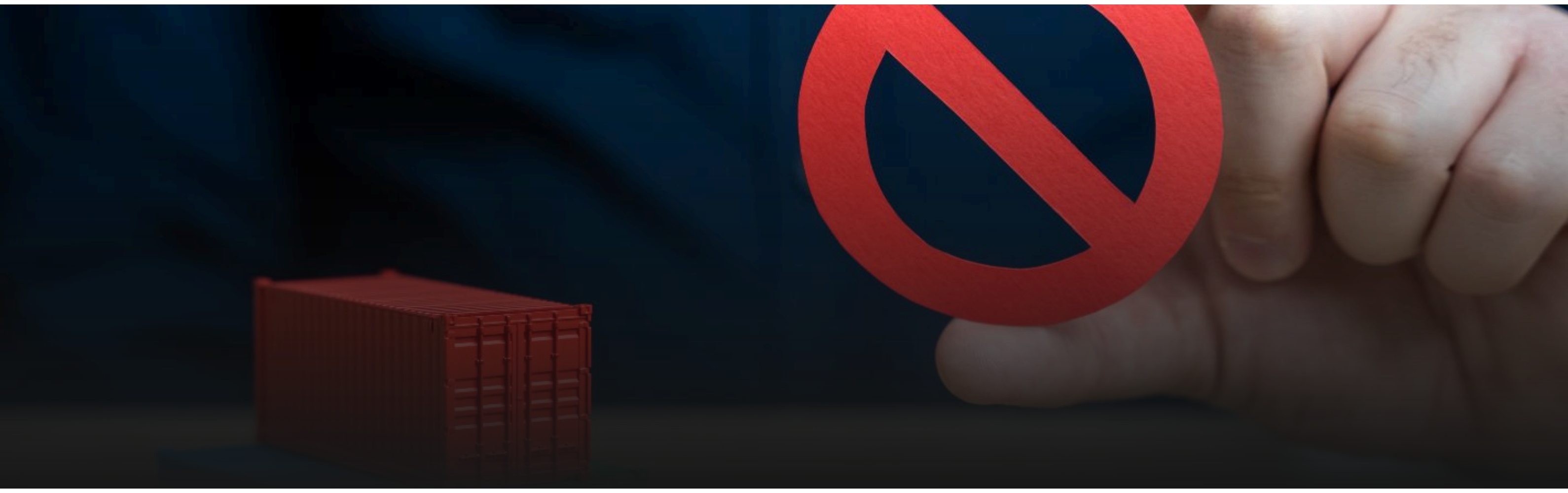

Adam Butlin January 13th, 2025

Trump's tariffs will put post-Brexit trade policy to the test

With Donald Trump's inauguration imminent, there are questions over the potential consequences of one of his signature policies: tariffs. While during the first Trump administration the UK wasn't too affected by the imposition of US import tariffs, a potential geopolitical escalation of a tariff war could have serious consequences for a British economy forced to choose between the EU and the US, writes ***Adam Butlin.***

The universal tariff proposals advanced by President-elect Donald Trump, including a 60 per cent tariff on US imports from China and up to 25 per cent on other imports, represent a substantial shift in trade policy. While similar proposals during Trump's first administration culminated in tariffs of approximately 20 per cent on Chinese imports, the evolving and unpredictable nature of these proposals highlights significant uncertainty.

Most economists agree that while the US may benefit from higher domestic production and increased government revenue, tariffs are likely to harm US households in the long term due to higher import prices and job losses in export sectors subject to retaliatory tariffs. However, there is much less clarity on the impact of new tariff proposals on other countries. I look at the ways in which the UK could be affected and where good or bad news on inflation and growth may come from. The consequences for the UK depend on our direct reliance on the US and the indirect impacts through the reverberations of US tariff policy on global markets.

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Impacts on UK inflation

Whilst the US is our largest individual trading partner, it still only accounts for around 10 per cent of UK goods imports. Furthermore, energy and other imports collectively comprise less than 40 per cent of the UK's Consumer Price Index (CPI) basket. As a result, the effect on the general price level may also be less than feared, and there is little evidence that any increase would translate into sustained inflation even in the most affected sectors. Evidence from the first Trump tariff war shows that the UK experienced a one-off rise in input costs but no significant inflationary persistence. This aligns with IMF research, which found that tariff shocks on intermediate goods tend to cause price level increases rather than persistent inflation.

Sectoral vulnerabilities

Growth effects may be acute in specific industries, but they are unlikely to be significant at the aggregate level. During the US-China trade war of Trump's first term, the UK exhibited relative resilience, with exports to the US growing approximately 10 per cent more than those of other US trading partners against the backdrop of a 25-30 per cent contraction in total US imports. However, certain UK industries remain vulnerable to adverse sectoral shocks. For instance, automotive manufacturers reliant on Chinese suppliers for EV batteries could face severe disruptions. Similarly, the electronics and pharmaceutical sectors, dependent on rigid supply chains involving specialized intermediate goods and critical minerals, may struggle to adapt to higher input costs.

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Policy uncertainty can reduce business confidence, discourage investment, and impact vulnerable sectors more acutely. The inconsistency of US trade policies during 2018 and 2019 was a significant source of uncertainty for businesses and investors. This unpredictability included the granting, reversal, and reapplication of tariff exemptions, which created widespread confusion and disruption in supply chains. For example, steel and aluminium tariffs were initially exempted for key US allies, only to be abruptly reimposed, leaving firms unable to plan effectively. The resulting trade uncertainty had tangible economic consequences, reducing US investment by about 1.5 per cent in 2018. The overall economic contraction and pressures on high value-added UK sectors with rigid supply chains, are likely to pose a drag on growth.

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Risks of Global Economic Fragmentation

The experience of the first Trump tariff proposals underscore how quickly trade tensions can escalate into a broader tariff war, as trading partners act decisively to protect their economic interests and signal their willingness to counter US measures. Following the imposition of steel and aluminium tariffs by the US on March 23, 2018, China swiftly retaliated on April 2. Their response included tariffs on aluminium waste and scrap, pork, fruits, and nuts – targeting specific US exports that impact agricultural producers and other politically significant sectors. On June 1 2018, the US ended its tariff exemptions for the European Union. The EU responded later that month, on June 22, by imposing counter-tariffs on iconic US exports like whiskey, jeans, and motorcycles. The speed and extent of retaliation expands the scope of tariff impositions, and can lay the groundwork for a broader escalation of trade barriers.

If heightened tariffs precipitate stricter barriers on the foreign content of imported goods, the resulting realignment of global supply chains along geopolitical blocs could profoundly affect economic growth globally. An orderly fragmentation scenario—characterised by a deliberate and systematic reconfiguration or diversification of trade relationships—may lead to a drag on long-term growth with more contained inflationary pressures.

In contrast, disorderly fragmentation, marked by a chaotic rush to secure limited suppliers, risks triggering inflationary pressure in the short term and constraining economic growth in the long run. Historical parallels, such as the destabilising effects of the Smoot-Hawley Tariff Act of 1930, underscore the potential for abrupt and uncoordinated trade policy shifts to amplify economic volatility. Given the increased complexity and interdependence of modern global value chains, these risks could be magnified, fostering uncertainty and economic instability.

The more profound implications of Trump's tariff proposals lie in their potential to fragment the global economy. This would have indirect effects on the UK, beyond the effects from direct exposure to the US.

Terms of trade dynamics

The direct exposure to the US through trade and the US dollar would increase imported cost pressures. But these can be more than offset by the global exposure of the UK. Tariffs of the magnitude that are being proposed are likely to impact world markets due to the large role of the US in the global economy. In theory, large economies can benefit from terms-of-trade gains when tariffs lead to reduced demand for imported goods, prompting their exporters to lower their prices. Evidence from the first Trump tariff war, however, is mixed. Chinese exporters largely did not reduce their export prices in response to tariffs in the first phase of the tariff war, with most of the burden falling on US importers. But commodities exporters, such as Chinese steel exporters, that rely heavily on competitive pricing in the US market reduced their pre-tariff prices by 50 per cent to safeguard their competitiveness in global markets. If Chinese exporters of steel, chemicals, and other key intermediate goods reduce their pre-tariff prices, UK manufacturers may face a smaller cost pass-through, mitigating the impact on consumer prices.

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interest.

A test for independent UK trade policy

In the aftermath of Brexit, the UK faces a pivotal challenge in defining its alignment with major economic blocs. A decision to strengthen ties with the US, deepen integration with the EU, or pursue a more independent trade policy will significantly influence the UK's ability to navigate an increasingly fragmented global economy.

As a first response, the UK should avoid aligning with one major bloc and pursue policies that are in its best strategic interest. With the US, this would include securing market access for heavily traded goods while maintaining its comparative advantage in services, where the US is an important trade partner. Committing to market access for US exporters would be straightforward in many cases, such as in energy or business services, where the economic relationship between the two countries already embodies mutual gains from trade.

After Brexit, the UK carried over the EU's rebalancing tariffs. However, trade relations between the US and the UK shifted on June 1, 2022, when the US agreed to allow steel imports from the UK. In exchange, the UK temporarily suspended its retaliatory tariffs on US exports until March 31, 2025. This agreement marked a step toward trade normalization and demonstrated a willingness on both sides to negotiate pragmatic solutions amidst broader trade tensions. If trade relations deteriorate, the UK could swiftly reinstate these tariffs without the standard requirement for an independent investigation by the Trade Remedies Authority. This flexibility adds a layer of uncertainty to the trade environment and highlights the conditional nature of ongoing agreements.

Retaliation needs to, as much as possible, be targeted towards goods and services where alternative sources of supply are available to reduce self-damage.

Despite progress on international cooperation in the past, the risk of escalating trade tensions remains. If retaliatory action becomes necessary, it could be most effectively implemented by coordinating with our largest trade partner – the European Union- and other trade partners, including those in the UK's network of international agreements. Coordinated retaliatory action means that less of a penalty needs to be imposed by individual countries to achieve the same amount of remedial action. Coordination on retaliation plugs leakages and increases the bargaining power of smaller economies in trade negotiations.

Retaliation needs to, as much as possible, be targeted towards goods and services where alternative sources of supply are available to reduce self-damage. Strategic industrial policies to support vulnerable sectors may also be needed to serve as short-term buffers. Enhanced engagement with countries offering diversified supply chains could reduce exposure to concentrated risks. In parallel, inventory building or incentivising domestic production of critical goods could strengthen economic resilience and ensure continuity during periods of global disruption. The UK Government's recently developed Supply Chains Resilience Framework provides a strategic blueprint for bolstering supply chain stability while fostering collaborative partnerships with key trading nations

The culmination of these factors points to a critical conjuncture for UK trade policy amid potential global fragmentation. In the eventuality that the UK may be forced to choose between its two largest trading partners, the EU remains our biggest trade partner and offers more trade policy certainty. But such polarisation of picking sides with one or another trade partner is not an ideal situation. This is a pivotal moment for the UK's independent trade policy and the long tradition of economic diplomacy. It now faces the complex task of ensuring that its openness does not get whittled down through trade tensions.

About the author

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