Trump's tariffs - the likely impact on inflation, spending and growth

Market insights

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The recent introduction of tariffs on Chinese goods by the US government has grabbed the headlines, leaving market participants to wonder about the consequences for the global economy.

Tariffs are a direct import tax, but because importers and import-using producers almost always pass on the higher costs completely to the end consumer, they are effectively a consumer tax.

Looking back at recent historical interactions between tariffs and consumer taxes, with inflation, real spending, and growth, we draw the simple conclusion that, **tariffs usually generate limited inflation and have a negative impact on real consumer spending and growth**.

In this short insight we explain why we believe this conclusion will hold true in the case of Trump's tariffs, and why US Gross Domestic Product (GDP) is likely to be more adversely affected, and for longer, than any rise in inflation.

The impact of tariffs on inflation and growth

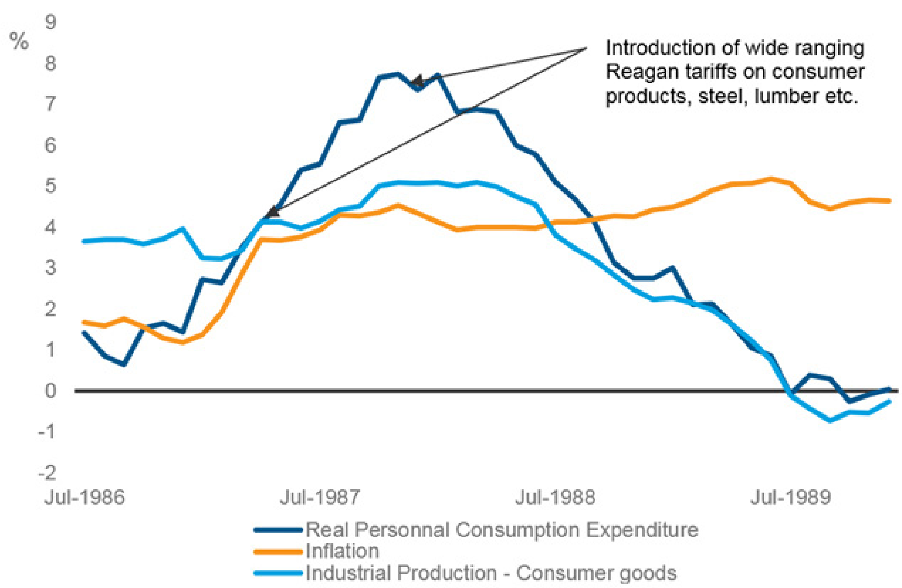
To assess the impact of tariffs on the economy of the country that introduces them, first we need to consider what they are.

Tariffs are a direct import tax, but effectively are a consumption tax - because importers and import-using producers almost always pass on the higher costs completely to the end consumer.

1987 United States direct import tax

One example of tariffs as a direct import tax is their introduction by the US Reagan administration in 1987.

Chart 1: Impact of the 1987 Reagan tariffs on the US economy



Source: Thomson Reuters Eikon

As can be seen from Chart 1, above:

1. Inflation rose at first, but did not accelerate
2. The volume of real spending on consumer goods fell after a lag, and continued falling for another two years[1]
3. Domestic production of consumption goods rose in anticipation of switching from imports, however as consumer spending growth decreased, production eventually followed.

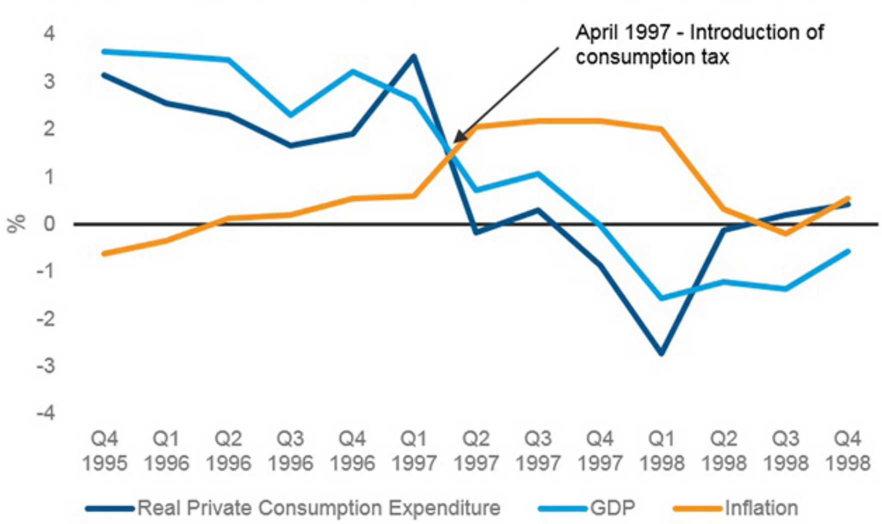
In this case, the impact of tariffs was a greater fall in real consumer spending, compared to a rise in inflation.

Japan 1997 and 2014 consumption taxes

As importers and import-using producers almost always pass on the higher costs completely to the end consumer, tariffs act like a consumption tax.

Japan introduced consumption taxes in 1997 and 2014. In both cases, the effect on inflation was muted, with real consumer spending falling more and remaining lower for longer.[2]

Chart 2: The impact of the 1997 Japan Consumption Tax on the Japanese economy

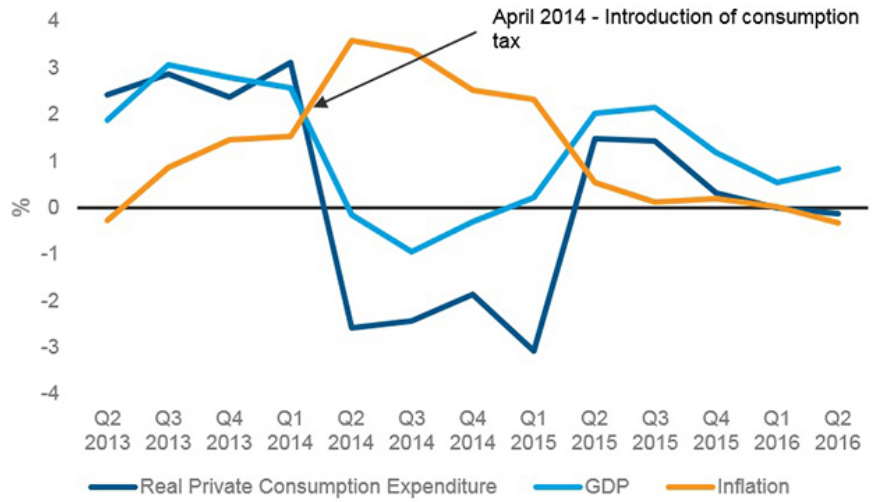


Source: Thomson Reuters Eikon.

As can be seen from Chart 2, above:

1. While prices rose temporarily, inflation returned to pre-consumption tax levels in 12 months or less
2. Real consumer spending fell by much more, and remained lower more than two years to three years later
3. It can be argued that inflation eventually fell lower than pre-consumption tax levels, due to the bigger decline in spending
4. The Japanese economy fell into recession which was exacerbated by the 1998 Asian Crisis.

Chart 3: The impact of the 2014 Japan Consumption Tax on the Japanese economy



Source: Thomson Reuters Eikon.

Chart 3 shows the impacts of the 2014 consumption tax followed a similar pattern to 1997: the rise in inflation was temporary, reversing in 12 months, while both household consumption growth and real GDP growth remained lower than pre-consumption tax levels for about two years.

In both instances, the impact of consumption taxes was a greater and more sustained fall in real consumer spending compared to a rise in inflation.

A local example, with a different outcome: Australia's introduction of the GST

In the year 2000, Australia introduced consumption tax in the form of the Goods and Services Tax (GST). Simultaneously, Treasury compensated the economy by putting in place a wide array of income tax relief initiatives, as well as lowering rates for other consumer-related taxes such as a reduction in fuel taxes. These measures had a wide ranging and significant compensatory effect. As such, the impact on consumer spending was muted. The effect on inflation remained short-term and not significant.

What's the likely outcome from US tariffs on the US economy?

Based on our research, we believe the introduction of tariffs in the US are more likely to have a significant negative effect on consumer spending, compared to a sustained inflationary effect. GDP is likely to be more adversely affected, and for longer, than any rise in inflation.

Our historical analysis also shows that the less robust the consumer, the stronger the spending reaction to a consumption tax, and the less significant the impact on inflation. Prior to the Trump tariffs, average 12-month US real retail sales growth was at 2.1%. Pre-1987 Reagan tariffs, the equivalent figure was at 4%. As such, the spending reaction could be even more adverse this time.

We also don’t believe the compensation from US tax cuts is significant enough to offset the adverse spending effect of tariffs. In Australia the tax cuts introduced to compensate the introduction of GST were wide ranging, reaching most consumers, while the US tax cuts are limited to a narrower part of the US consumer base and on a less permanent basis.

We believe the implication for fixed income investors is that bond yields may increase due to very short term general price effects but ultimately will remain contained as growth is negatively impacted and inflation reverts to its normal trend.

[1] Although the intensifying of Savings-Loans issues in late 1988 and 1989 did also contribute to consumption woes

[2] While there were other factors, the consumption tax was a major contributor to slower Japanese spending. For example, Japan Cabinet Office Report 1998 stated “…the rise in consumption tax resulted in a larger-than-expected dip in spending…” http://www5.cao.go.jp/99/f/kaiko-e/kaiko-e.html