Trump's Tariff War

A test of political game theory: Short-term gains, long-term pain

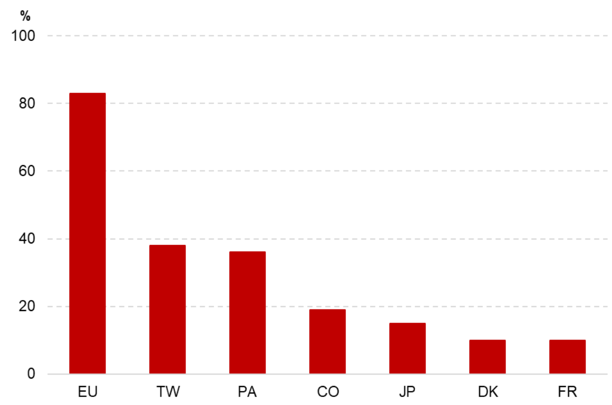
OVERVIEW

- Trump's tariffs on China, Mexico, and Canada risk disrupting supply chains and unsettling markets. Renewed threats against the EU and UK add to global trade uncertainty. A 30-day pause for Mexico and Canada, secured through border security pledges, offers brief relief, but China remains the primary target.
- While tariffs provide short-term boost to US industries, they fuel inflation and trigger retaliation. Trade rivals may further reduce USD reliance, strengthening blocs like BRICS and Regional Comprehensive Economic Partnership (RCEP). Protectionism risks isolating the US as alternative financial systems emerge, challenging its global dominance.
- Tariffs act as a hidden tax, disproportionately burdening low-income households by raising prices on essential goods. Inflation risks rise as businesses pass higher costs to consumers. While supply chain adjustments may soften the blow, weaker household spending could dampen US economic growth.
- Tariff-driven inflation complicates the Fed's rate path, potentially limiting cuts to two in 2025 if trade tensions escalate. The USD strengthened as investors sought safety, while growth-sensitive currencies weakened. Despite pressure on the MYR, we maintain a 4.45/USD forecast, supported by robust domestic fundamentals.

CONTEXT

- **Trump's Tariffs Stoke Global Trade War**
  - President Donald Trump has escalated trade tensions by imposing new tariffs on imports from China, Mexico, and Canada, aimed at tackling illegal immigration and drug trafficking. These tariffs have disrupted global supply chains and triggered retaliatory moves from these nations. The economic repercussions are significant, including higher consumer prices, distorted trade flows, and heightened market volatility.
  - Trump has also renewed threats to target the EU and potentially the UK with tariffs, further compounding global trade uncertainties. The prospect of a wider trade war has rattled markets, with European and UK stock markets experiencing sharp declines as fears of escalation grow.
  - **LATEST UPDATE:** Canada and Mexico struck agreements with Trump to suspend tariffs for 30 days after pledging border security measures, including troop deployments. However, tariffs on China will take effect as planned tomorrow. In response, China has opted for a more targeted approach, imposing tariffs, tightening export controls, and restricting market access.

Graph 1: Which Countries will Trump Tariff in his first 100 days?



Source: Polymarket, Kenanga Research

TARIFF IMPACT: SHORT-TERM GAINS, LONG-TERM COSTS FOR THE US

- **Immediate US Gains, but at a Cost**
  - Trump's tariffs may deliver short-term benefits for the US, particularly in steel, aluminium, and automotive industries, where domestic producers gain temporary relief from foreign rivals. Key initial impacts include: (1) job growth in protected sectors; (2) narrower trade deficits in targeted industries as imports become costlier; (3) negotiating leverage in trade negotiations as trade partners face pressure to concede.

- However, these gains come with consequences (1) higher consumer prices as businesses pass on costs to consumers; (2) retaliatory tariffs, as affected nations counter US measures, disrupting global supply chains.

- **Trade Wars Through the Lens of Game Theory (Prisoner's Dilemma)**

  - The dynamics mirror the Prisoner's Dilemma: nations must choose between cooperation (free trade) or defection (tariffs). If the US imposes tariffs unilaterally while others refrain, it gains short-term advantages. In reality, retaliation follows, where all sides impose tariffs, escalating trade tensions.

  - Repeated tariff use erodes trust, pushing economies to diversify and reduce reliance on US trade. The EU's strategic autonomy push and China's dual circulation strategy (prioritising domestic supply chains) reflect this shift. Over time, the US risks losing its position as the fulcrum of global trade, as alternative blocs like the BRICS and RCEP gain prominence. The latter is the world's largest trade bloc by GDP, covering about 30.0% of global trade.

- **Erosion of USD Hegemony**

  - The weaponisation of the USD in trade and sanctions is accelerating the global search for alternatives to reduce USD reliance:

    - **Local currency settlements:** BRICS members are expanding non-USD trade by raising financial transactions in local currencies. Saudi Arabia has even considered yuan payments for oil, weakening the petrodollar system.
    - **New financial system:** The BRICS bloc is developing alternatives to US-centric financial infrastructure, such as BRICS Pay.
    - **DeFi and CBDCs:** Short for Decentralised Finance, DeFi is a blockchain-based financial system that operates without traditional intermediaries like banks and brokers while central bank digital currency (CBDC) is a digital form of a country's fiat currency, issued and regulated by the central bank. DeFi is gaining widespread adoption due to its transparency, accessibility, and design to be permissionless. China's digital yuan, one of the pioneers of CBDC, already tested for cross-border transactions, could provide an alternative for sanctioned entities. Russia and Iran have integrated financial messaging systems to bypass SWIFT, while China's CIPS continues expanding.

- **Impact on ASEAN**

  - **Opportunity amidst risk.** For ASEAN, this presents both risks and opportunities. Countries like Vietnam, Malaysia, Thailand, and Indonesia stand to gain from trade diversion, as companies seek alternative manufacturing hubs to bypass US-China tensions. Foreign direct investment into ASEAN could rise as multinational corporations may accelerate "China+1" strategy, particularly in electronics and semiconductor manufacturing. However, the region's deep integration with China's supply chain means any slowdown in Chinese exports could indirectly affect ASEAN economies, especially those reliant on intermediate goods and raw materials.

  - **Non retaliatory options.** Beyond trade, the geopolitical stakes are high. ASEAN nations may face pressure to align more closely with either the US or China, complicating their traditionally neutral stance. While some might benefit from closer trade ties with the US, others risk exposure to broader protectionist measures. To maximise gains, ASEAN governments are expected to raise their competitiveness, strengthen trade agreements, and invest in resilient supply chains to navigate these shifting global dynamics.

TARIFF RETALIATION

- **Retaliation Mechanisms: Escalating the Trade War**

  - **INITIAL REACTION:** Prior to the trade talk, countries targeted by US tariffs have responded with calibrated countermeasures, turning trade tensions into a high-stakes game of chicken, where neither side wants to back down for fear of losing geopolitical face or domestic political support.

    - **Canada:** Immediately announced retaliatory 25.0% tariffs on USD106.6b of US goods, covering everything from beer and wine to household appliances and sporting goods.
    - **Mexico:** Sought dialogue but warned that it would be forced to implement tariff and non-tariff countermeasures if talks failed, emphasising the need to protect national interests.

  - **China** has pledged "necessary countermeasures" in response to the new US tariffs, calling them a violation of WTO rules and vowing to challenge them legally. Unlike Canada and Mexico, which secured temporary reprieves, China faces a tougher path to meeting Trump's economic and political demands. Hopes for a swift resolution now appear increasingly uncertain.

  - As part of its retaliation, China has announced tariffs of up to 15.0% on US coal, liquefied natural gas, agricultural equipment, and oil, set to take effect on February 10. These measures signal a deepening trade conflict, with both sides showing little willingness to compromise. If tensions persist, global supply chains could face further disruptions, and market volatility may intensify.

ECONOMIC EFFECTS ON CONSUMERS AND INFLATION

- **Tariffs Hit Low-Income Households Hardest**: Tariffs act as an indirect tax on consumers, raising prices on imported goods. While protecting domestic producers, they disproportionately burden lower-income households, who spend more on goods than services. As household budgets tighten, this could shift consumption patterns, slowing economic growth.
- **Inflationary Pressures**: Tariffs typically drive inflation by raising costs for import-reliant businesses. If passed to consumers, this could push up overall prices, though the impact depends on demand elasticity and supply chain adjustments.
- **Mitigating Factors**: While this represents a worst-case scenario, some effects may be offset by: (1) substitution to US-made goods or alternative suppliers; (2) cost absorption along the supply chain by foreign exporters, importers, and retailers; (3) delayed consumer impact as businesses sell existing inventories as seen in 2018, given that tariffs take time to filter through. Even with these offsets, tighter household budgets could reduce discretionary spending, weighing on consumption growth—an essential driver of the US economy.

THE FED AND USD OUTLOOK

- **Fed Policy Outlook, A Balancing Act:** Tariff-driven inflation adds complexity to the Fed's policy path. While higher prices could justify a cautious approach to rate cuts, uncertainty over economic conditions—ranging from temporary trade disruptions to broader slowdowns—complicates decision-making and could delay action. With limited precedent for mega tariffs in the modern economy, policymakers may wait to assess the full impact of last year's 100 bps reduction before adjusting further. We maintain our expectation of 2-3 Fed rate cuts in 2025, but now lean toward two rather than three if the trade war escalates.
- **FX Outlook, USD Resilience:** The USD rallied defensively following Trump's tariff escalation, as investors sought safety amid trade war fears. Growth-sensitive currencies, particularly commodity-linked FX, weakened. However, markets stabilised after the US paused new tariffs on Mexico and Canada for a month, reinforcing the view that tariffs remain a transactional tool. We remain cautious on US-China tit-for-tat trade war and the potential tariffs on EU. If tariffs drive higher US inflation, the USD may stay supported as the Fed may cut rates less than expected. We maintain our MYR forecast of 4.45/USD by end-2025, underpinned by stable domestic fundamentals and expected Fed easing in 2H25.

CONCLUSION

- Attention now shifts to the imminent Trump-Xi dialogue and the risk of Trump escalating trade tensions with the EU. A prolonged tit-for-tat cycle risks a mutually damaging standoff, with neither side backing down. However, **we remain optimistic that negotiations will prevent a full-blown tariff war**. While the 10.0% tariff on China is less severe than the previously threatened 60.0%, it remains a tangible cost.
- Financial markets have reacted negatively, with the ringgit coming under pressure and potential capital outflows weighing on sentiment. However, **we see no immediate or lasting inflationary impact on Malaysia**. On the contrary, **growth prospects remain positive**. Malaysia stands to gain from the "China+1" strategy, particularly in the E&E sector, where it remains a key regional hub. That said, if Trump proceeds with a broader 10.0% universal tariff, downside risks to growth would rise.

For further information, please contact:

Wan Suhaimie Wan Mohd Saidie
Head of Economic Research
wansuhaimi@kenanga.com.my

Muhammad Saifuddin Sapuan
Economist
saifuddin.sapuan@kenanga.com.my

Afiq Asyraf Syazwan Abd. Rahim
Economist
afiqasyraf@kenanga.com.my

Nurul Hanees Hairulkama
Economist
nurulhanees@kenanga.com.my

Published and printed by:

KENANGA INVESTMENT BANK BERHAD (15678-H)
Level 17, Kenanga Tower, 237, Jalan Tun Razak, 50400 Kuala Lumpur, Malaysia
Telephone: (603) 2172 0880   Website: www.kenanga.com.my   E-mail: research@kenanga.com.my