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Economist's Weekly Market View

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Could the market rout force a Trump U-turn?

Last week's salvo of tariffs by the Trump administration raised the stakes for global trade partners, particularly those hit hardest in Asia and Europe. The EU tariff is to be set at 20%, with a carve out in some areas for now, such as semiconductors, lumber, and crucially for Ireland, pharmaceuticals. In Asia, major exporters such as China, Vietnam and Japan will have tariffs at much higher rates than the EU. Comparatively, the UK has fared better, with a tariff rate of 10%.

The choice for these countries now is to fulminate and retaliate, running the risk of a further escalation from the US, or hold fire and seek to negotiate. For now, institutional forecasters predict the greatest damage from unilateral US tariffs will be to the US economy. These models show the damage accumulates as other regions respond in kind to the US tariffs. In that context, further market turmoil or a rapid deterioration in the US economy might yet persuade Trump to row back on the announced tariffs. However, even if Trump relents somewhat, both markets and global trade partners must now price in a higher baseline for US tariffs and lower GDP growth in the short-to-medium term.

The question now is whether the global economy can absorb the impact of the isolationist turn by the US. The dollar remains the key currency for global financial markets, involved in 90% of FX transactions and c.85% of swap market trades, according to the Bank for International Settlements. Nonetheless, the proportion of global FX reserves held in dollars has fallen steadily in recent decades from 73% in 2000 to less than 60% by 2023, according to the IMF. Indeed, while the dollar still dominates financial markets and global reserves, the US economy accounts for a much lower share of global GDP at 25%. Moreover, and crucially in the current climate, US imports as a proportion of total global imports is even lower at less than 15% and set to shrink further. That leaves 85% of global trade unimpacted by the 'Liberation Day' tariffs.

Therefore, the challenge for the other major economic blocs in Europe and Asia is to double-down on the rules-based global trade order, going it alone without the US, or seek to retaliate against the US and follow suit with each other. The first test will come soon for the EU. Given the level of tariffs applied to South East Asian countries, the EU will likely introduce some short term trade barriers to prevent product dumping. However, the long-term opportunity for Europe might be in completing more comprehensive trade deals with these trading blocs which boosts the remaining 85% of global trade. At the same time policymakers should now accelerate the competitiveness agenda within the EU, as laid out in last year's Draghi Report.

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