Trump's reciprocal tariff surprise will prompt stronger China response

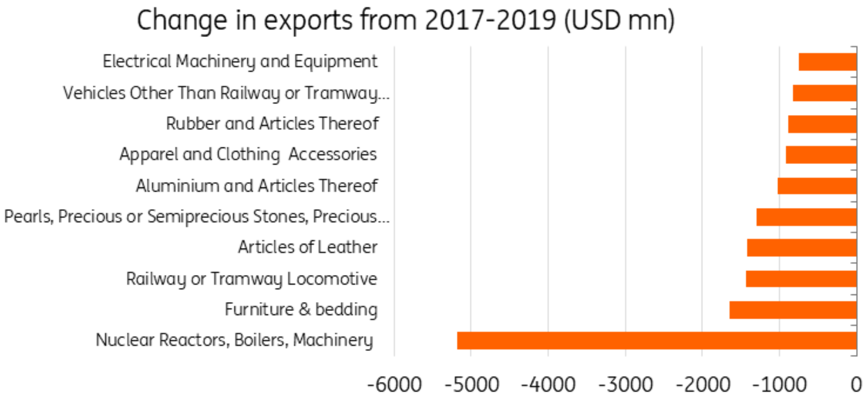
Higher-than-expected US tariffs will drag on Chinese growth and inflation this year. China has been quite measured in its reaction to the first two rounds of tariffs. But a sharp 34% tariff escalation risks a stronger response both in terms of domestic stimulus and potential retaliation

Source: Shutterstock

Latest round of escalation brings tariffs on China close to Trump's campaign trail promises

President Trump imposed a 34% reciprocal tariff on China, which is reportedly on top of an earlier 20%, bringing the tariff rate to 54%. This brings us close to the "worst case scenario" of 60% tariffs Trump threatened on the campaign trail, with certain products such as electric vehicles seeing even higher tariffs. With this abrupt move, the odds of a stronger retaliation from China have risen.

Hardest hit sectors in the first trade war



Rapid escalation of tariffs risks bigger hit to growth this year

Last year, China's trade surplus with the US accounted for around 2% of GDP. We have been forecasting a drag between 0.4-0.8ppt on 2025 growth, assuming an eventual escalation of tariffs to 60%. We are maintaining our scenario for now. However, this faster-than-anticipated escalation likely puts the impact toward the higher end of that band.

It should be noted that the calculus for China is different from many other countries seeing tariffs for the first time.

- Many of China's most price-sensitive exports to the US with international competition were already gradually phased out in the first trade war.

- With numerous other economies also being hit with tariffs, this actually ends up reducing the availability and attractiveness of substitution products for China's exports. However, it also impacts China's re-export channels.

- Impacts could change depending on whether or not the US ends up closing the de minimis trade exception, where imports with a value of under USD 800 are exempt from tariffs. This currently provides an avenue for e-commerce companies to make direct sales to US end consumers without the tariff impact.

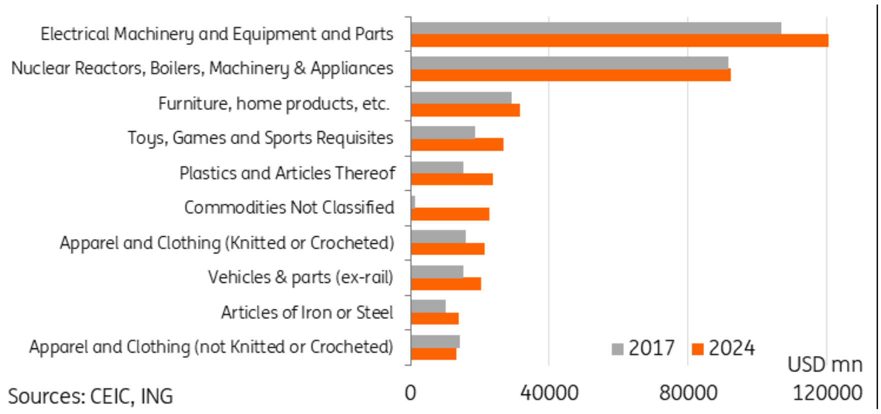
- The extent of retaliation remains unclear, which will play a role in how the bilateral trade balance actually develops.

We have the experience of the first trade war to draw upon. Studying China's top export categories to the US during the first trade war gives a good picture of how things might develop this time. Price-sensitive categories with more substitution products, such as furniture and apparel, were hardest hit. The same with potentially sensitive exports in the nuclear reactors, boilers, and machinery categories.

However, China's largest export category to the US, electrical machinery, equipment and parts, was not heavily impacted in the first trade war. Many specific exports have limited-to-no alternative suppliers. As such, tariffs could ultimately be borne by US importers. Furthermore, most categories recovered and surpassed previous export levels after an initial shock.

A drop in external demand has been well expected in China since Trump's election victory. Amid strong external headwinds, the success or failure of China meeting its "around 5%" growth goal this year is dependent on whether measures to boost domestic demand are successful.

China's biggest exports categories to the US in 2024



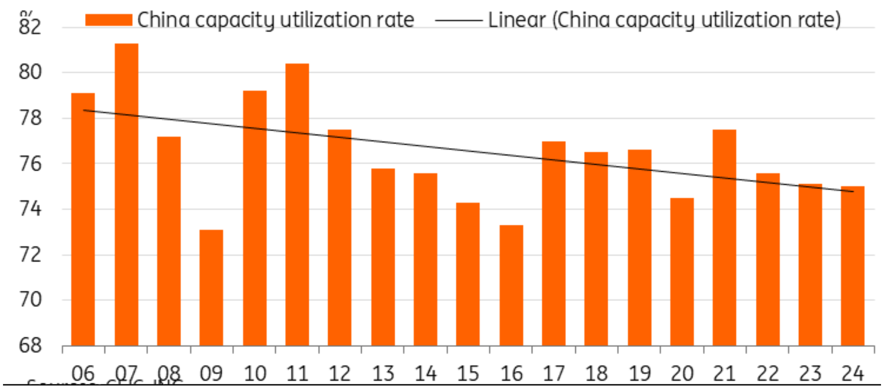
Deflationary pressures and overcapacity concerns could worsen

China has been struggling with inflation persistently below target for the past few years, prompting the official target to be lowered from 3% to 2% this year. Even considering the lower target, it looks unlikely to be reached this year.

Tariffs will likely add to deflationary pressure, as products which once could've been sold in the US market will now need to be re-directed elsewhere -- or absorbed by domestic demand.

Ultimately, tariff barriers seem likely to exacerbate overcapacity issues. China's capacity utilisation rate has trended downward for three straight years, settling at 75% at the end of 2024. Worsening overcapacity could lead to further price competition and thus deflation. Eventually, further industry consolidation seems likely. Risks to our inflation forecast, currently set at 0.7% year on year for 2025, are looking skewed to the downside.

Overcapacity concerns could further add to downward price pressures

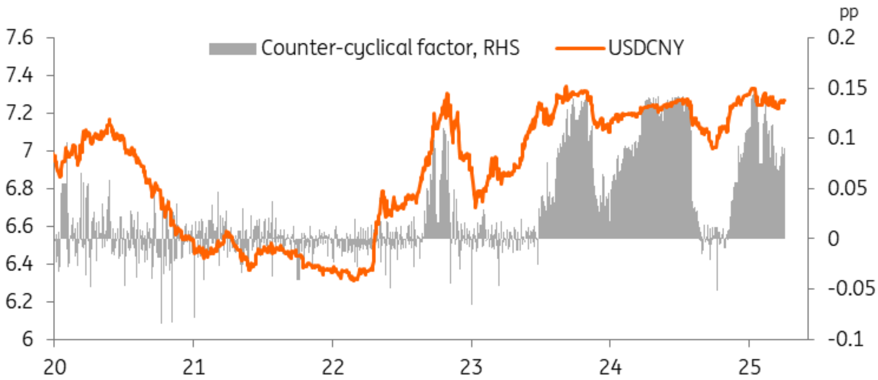


Tariffs could prompt PBOC easing, but don't expect significant CNY devaluation

Amid deflationary pressure and the potential hit to growth, the People's Bank of China (PBOC) could be incentivized to ease policy for the first time this year. This follows earlier vows to ease within a suitable timing window. We're looking for 30bp of rate cuts and 100bp of reserve requirement ratio (RRR) cuts this year with room for more. Given last year's experience, we think it's likely that rate and RRR cuts could be bundled together for better effect.

For the CNY, the latest round of tariffs will likely add further depreciation pressure in the near term as investors digest tariff impacts – and the odds of PBOC policy easing increase. However, it will do little to change our baseline scenario. We don't expect the PBOC to intentionally devalue the CNY to offset tariffs. This means the currency stabilisation objective remains in place, leading to the USDCNY remaining a low-volatility currency. Our expected fluctuation band remains at 7.00-7.40 for the year.

We expect the PBOC to continue to hold the line this year on the CNY



Sources: Refinitiv, CEIC, ING

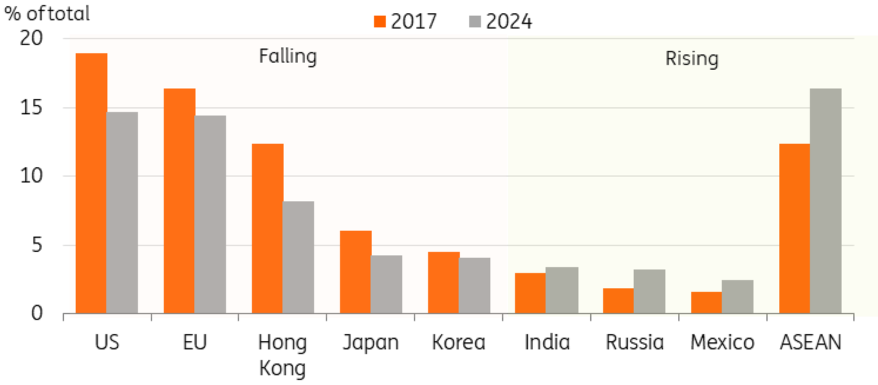
Tariffs will accelerate recent decoupling trends

The escalation of tariffs represents a significant accelerator of recent trends. Amid all the talk of the US de-risking China, it's important to note that China has been gradually de-risking the US market as well. The proportion of China's total exports to the US has fallen from around 19% in 2017 to 14.6% in 2024. While the US is still obviously a very important market, fewer firms are now existentially dependent on US suppliers or consumers compared to before the first trade war.

Long-term trends of tech self-sufficiency are likely to remain in place due to tariffs, sanctions and other international barriers -- but also because of China's long-term strategic transition to a more innovation-driven economy.

Tariffs will probably not be too effective in addressing long-term trade imbalances between the US and China. At this stage, China simply has comparative advantages in many manufacturing categories. While the US can close off its borders, China's retaliation can also cut off US exports to China. A big barrier to rebalancing trade is that the US puts export controls on products for which China would actually like to ramp up imports, namely its hi-tech exports. Due to strategic competition issues, this doesn't look likely.

De-risking could prompt a stronger retaliation this time around



Sources: CEIC, ING

The path forward narrows

The key question moving forward is how countries will respond -- whether or not they will carry out negotiations or push back with stronger retaliation.

Treasury Secretary Scott Bessent earlier indicated that this round of tariffs was expected to represent a cap on levies as long as there is no retaliation. And that countries will be able to take measures to reduce tariffs. This seems to imply there will be room to mitigate the damage in the coming weeks and months.

We wrote back in January that the path to avoid a more destructive US-China trade war is a narrow one and the latest measures will only further narrow this path.

Moving forward, the next key date for China could be 5 April, when Trump's moratorium on the TikTok ban in the US expires. While Trump could ostensibly extend this deadline further, there will certainly be some pressure to close a deal. Trump previously mentioned the possibility of lowering tariffs as a sweetener to get a TikTok deal done. However, given the latest round of escalations -- and concerns over the Panama Canal -- it remains uncertain if China will even approve such a deal.

In our view, repeated escalations make the prospects of a grand bargain increasingly unlikely. China's response to the latest measures will shed much light on how policymakers in China feel about the prospects of such a deal.

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