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Navigating the Trade Storm: Multilateral Flanking of US Transactionalism

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Navigating the Trade Storm: Multilateral Flanking of US Transactionalism

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With near constant change in Donald Trump's bilateral tariff policies, the global economy finds itself in uncharted territory. On top of Trump's various tariff increases, we have witnessed tariff-based retaliation, U.S. retaliation against the retaliation, and non-tariff retaliation targeting U.S.-based MNEs in the service sector. We have also seen on-again off-again changes to US bilateral trade policy, with tariffs announced, delayed, walked back, and reintroduced. Official statements on tariffs contradict previous statements. This has all taken place in the broader context of confusion and uncertainty about key elements of US macroeconomic policy – taxes, monetary policy, scientific funding, and the stability of US regulatory frameworks to name just a few. All of this carries the scope for very real economic costs for third countries. In this policy brief we examine recent changes in US trade policy, along-side possible flanking measures (policy responses) and the impact of increased risk costs for US investors. To do this we work with a large scale Computable General Equilibrium Model (CGE). We first assess the long-run impact of the current tariffs on economies around the world, and then we show the potential impact of a pro-active pro-trade multilateral response by the rest of the world. This includes increased risk premia tied to continued investment in the U.S. economy.

We first adopt a scenario close to the current situation, assuming a limited trade war and focusing on long-run outcomes from the change in policy. This scenario incorporates the new general 10% tariff on all U.S. imports, excluding USMCA-qualified goods (announced on April 2, 2025), followed by reciprocal tariff measures announced on April 6, 2025. Additional tariffs include a 25% duty on electronics, metals and autos. A tit-for-tat trade dynamic with China includes tariffs of 125% on U.S. goods and 145% on Chinese goods, with the rest of the world refraining from further retaliation in this initial scenario. While there has been talk that tariffs will be lower, or not, we take these as they are now. Lower tariffs require dialogue, and while the U.S. Administration has claimed there is such dialogue, their Chinese counterparts deny any such discussions. The scenario also includes tit-for-tat tariffs by USMCA partners (Canada and Mexico) against the US for non-USMCA compliant products. We have based the electronics tariffs, which have not yet been set, on the tariffs for autos and metals. This scenario also includes an increased risk premium on U.S. investment. We've positioned it at a level that now aligns the U.S. with economies perceived as carrying higher risk, higher than the UK and closer to economies like China. This elevated risk premium affects the U.S. current and capital account balance and alters long-run capital stock levels.[1]

[1] We model a 0.87% increase in the risk premium for the US in the first scenario. This contributes -0.37% to the estimated drop in US GDP overall. Even stronger estimated effects of changed US risk premia are reported by the Yale Budget Lab. "Even a relatively modest move in risk premia would have profound implications for the US. If the US country risk premium moved to that of the current UK level, after 10 years, real equity wealth per household would be $50,000 lower and real GDP 1% smaller." E. Tedeschi,

The modelling results paint a stark picture, with long-run U.S. GDP estimated to contract by 4.98% (see Table 1) in the long run (after 10 years). This decline is almost double the estimated -2.52% GDP reduction for Vietnam, the second most affected economy. There are strong negative effects across East Asia, while the European Union would see GDP shrink by about -0.65% and China by 0.96%. The variation across countries is driven by a combination of direct US tariff changes on exports from those countries, a redirection of trade between third countries in response, and a reallocation of global investment. The UK and Swiss effects are dominate by a shift in investment to those economies.

The outcome of this scenario does little to address Trump's stated goal of reducing trade imbalances in the manner desired. Improvement only comes at the cost of lower general levels of trade and investment, including dropping US exports. We estimate that while total imports would decrease by 23%, there would also be a 37% drop in total exports. Trade activity for all is expected to decline, with Mexico being an exception only because it is hit less hard than other major US trade partners. The most dramatic shifts are anticipated bilateral trade with the U.S., with Chinese and Vietnamese exports to the U.S. estimated to drop by roughly 80% each. Indeed, most nations are expected to see a significant decrease in their exports to the U.S., with USMCA partners partially filling the gap (though again Canada sees GDP drop).

Table 1: Macroeconomic effects of trade war and flanking response

Political Risks to the U.S. Safe Harbor Premium, May 2024, https://budgetlab.yale.edu/sites/default/files/2024-05/The%20Budget%20Lab%20Safe%20Harbor%20Analysis%202024_0.pdf
For recent estimates of risk premia, we work with estimates from A. Damodaran, *Country Default Spreads and Risk Premiums*, NYU Stern School of Business, January 2025. https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

Faced with the potential significant negative effects of current U.S. trade policies, a logical question is how to respond. The United States has chosen an aggressive unilateral trade policy, combined with strategic pressure on individual countries for perceived economic gain. The agenda is one of divide-and-conquer transactionalism. We know from game theory (and history) that collectively the world will not be better off leaving individual countries to be picked off one at a time with bilateral deals reached under duress. So, what is the alternative? In our view, one logical response from the rest of the world could be to double down on the multilateral system, deepening trade integration amongst themselves. Recent signals suggest that this could be already on the table as an option. For instance, China has publicly expressed its intentions for trade talks with the EU, explicitly framing it as a countermeasure to perceived U.S. trade 'abuse' ("China wants partnership with EU to counter US 'abuse'" as reported by Reuters on the 16 of April")[2] .

To understand how this would change the potential outcomes over the long-run, we have also examined a second scenario where in contrast to the limited trade war scenario, we model a full-scale global trade war, but one that is flanked by the rest of the world pursuing a new multilateral liberalization round. This involves all other countries — excluding the U.S. — and features cutting tariffs by 50% and a 3% average ad valorem equivalent (AVE) decrease in services trade costs. With the US not taking part, this further isolates the U.S. in global trade dynamics but generally offsets losses (in most cases completely) for the rest of the world.

While the same baseline tariffs, reciprocal measures, and U.S.-China tit-for-tat dynamics are maintained, this scenario escalates further by including retaliation from the EU, which imposes 25% tariffs (with additional duties on electronics, autos and steel), prompting a second round of tariffs from the U.S. in response The rest of the world also responds with mirrored retaliation, matching U.S. tariff levels, followed by U.S. countermeasures. These are based on the proposed reciprocal tariff rates. Moreover, there is a new layer of retaliation targeting U.S. services exports, imposing 5% ad valorem equivalent (AVE) costs. Finally, in line with the current US treasury bond yield increases as a reaction to Trump's tariff announcement, we assume a significantly higher risk premium for the U.S.— 2.5%, placing it in line with higher-risk economies such as Brazil, Hungary, Italy, Mexico, and Spain.

The consequences for the U.S. economy in this combined full-scale trade war and multilateral flanking scenario are substantial. These effects are summarized in Tables 1 and 2. U.S. GDP levels are estimated to fall by approximately 7.4% (i.e., 7.4% lower levels into the future.) In stark contrast to the effect on the US, most other countries would gain, some with significant increase in their GDP. Only Canada, Taiwan, Singapore, and Vietnam would continue to have a decrease in their GDP. These are countries particularly exposed to market access in the U.S. Yet even for these countries, the flanking multilateral liberalization exercise reduces their losses from the trade war substantially. In the case of Vietnam for example, a -6.53% reduction in annual GDP

[2] https://www.reuters.com/world/china-wants-partnership-with-eu-counter-us-abuse-says-envoy-spain-2025-04-16/

levels is moderated to a -1.05% loss. Of course, gains would be broader, also for the U.S., if there was no trade war. However, given aggressive unilateral moves by the U.S., multilateral cooperation on a trade liberalization exercise, signalling commitment to open markets, essentially offsets global losses (excluding the U.S.) from the trade war itself, with space to compensate the remaining losers. Under this scenario, the reallocation of capital away from US markets plays an important role in offsetting the tariffs alone. In many European countries for example (for example Germany, Switzerland, Italy, and Spain), this effect more than offsets the direct effects of tariffs on trade with the U.S. Globally, industrial production shifts away from the U.S. not only because of supply chain disruption, but also because of the general environment of greater policy uncertainty in the U.S.

Table 2: Macroeconomic effects of trade war and a multilateral flanking response

Mirroring the limited trade war scenario, total U.S. trade (both imports and exports) again falls, with import volumes falling less than export volumes (38% vs 50). The global impact on trade volumes (exports) is show in Figure 1. USMCA exports drop, while the most other countries have changes ranging from modest drops to significant increases in export volumes.

In conclusion, our analysis paints a concerning picture of the potential long-run damage inflicted by a U.S.-centred war, particularly on the U.S. itself. The likely long-run impact of such a structural shift in U.S. policy involves a structural decline in U.S. GDP levels. However, the contrasting outcome when a full US vs World trade war is flanked by the rest of the world with a multilateral liberalization effort offers an important insight. A concerted effort towards further market opening can offset US-based losses and move the global economy (excluding the US) forward. This underscores the critical importance of pursuing and strengthening multilateral frameworks as a vital counterweight to unilateral impulses and a pathway towards a more resilient and prosperous global economy for those who reject isolation. Of course, the structure of such an exercise also poses challenges. A substantial share of potential benefit from such liberalization follows from countries outside the OECD offering better market access to each other (see Table 2). As such, a multilateral response to US transactionalism requires that non-OECD countries take a greater role in the stewardship of the trading system.

Figure 1 Percentage change in exports, long-run full trade war with multilateral flanking