United Nations University
Institute on Comparative Regional Integration Studies

INSIGHTBRIEF
No. 3, 2025

The Real Cost of a Trade War

Examining the Fallout of US Tariffs

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Background

Just days after his inauguration, US President Donald Trump announced plans to impose a 25% tariff on two of the United States' closest trading partners, Canada and Mexico, along with a 10% tariff on China. He justified these tariffs with a wide array of claims, including eliminating the US trade deficit, bringing jobs back to America, combating illegal immigration, and curbing the smuggling of fentanyl.

After a short one-month-long respite for Canada and Mexico, following commitments on their part to increase border security efforts, all of President Trump's tariffs came into effect on the morning of 4 March, before being suspended two days later on 6 March for one additional month. For China, this came on top of the additional 10% that already became applicable a month earlier. All three countries have now announced retaliatory measures against the United States.

These tariffs will have pervasive consequences on all four economies, especially given how intertwined they all are. President Trump is picking a fight with some of the United States' largest trading partners: in 2022, approximately 45% of its total imports came from the three countries. China was the top import origin, accounting for nearly 18% of US imports, followed by Canada at 14% ($438 billion), and Mexico at 13.5% ($421 billion). The US primarily imports machinery from China, crude and refined petroleum from Canada, and transportation

Highlights

The previous trade war was a failure on all accounts for Trump: the trade deficit was not cancelled and his policies cost Americans their jobs. A trade war on a larger scale with bordering countries will be as damaging if not more.

Due to the size of the American market, tariffs will undeniably considerably hurt its affected partners.

Retaliatory tariffs, while understandable, will only further the cycle of losses for all actors involved in this trade war.

This trade war threatens CUSMA and further risks the region's economy.

The tariffs are unlikely to improve the trade deficit or the value of the dollar and will worsen problems like inflation and decreasing competitiveness of US manufacturing.

Reshoring looks compromised and the trade war is unlikely to benefit the average American worker.

A trade war is never without suffering and, whether economically or politically motivated, the analysis suggests the tariffs are likely to be painful for the American people.

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products like cars and trucks from both Canada and Mexico. Mexico alone is a huge source of food for the US. 63% of vegetables and 47% of fruit and nuts of their imports in those categories come from there, highlighting their dependency on their southern neighbour. Tariffs on those products will most likely put pressure on the cost of living in the US. However, the consequences for Mexico will also be dire: nearly 80% of Mexico's exports go to the US. Moreover, agricultural products do not travel easily, making it difficult for Mexico to find another market. Likewise, the oil transport infrastructure is tailored to the US market, increasing the potential costs of switching trade partners.

Despite the obvious short-term disruptions President Trump's policies will cause, is there a silver lining for the American economy that awaits his country after the dust has settled? All theories and evidence suggest this will fail to deliver on President Trump's promise of the economic rebirth of the country.

The Positive Outlook

In the absence of any retaliatory measures, the immediate effect of an ad valorem tariff (calculated as a percentage of the value of the product) would be a reduction in American demand for imported products and an increase in domestic production. Given the significant size of the US market worldwide, exporters from affected countries, such as Canada, might lower their prices to counteract the decline in demand. As a result, prices in American markets would rise — but not by the full amount of the tariff. This could lead to terms-of-trade gains (i.e., a reduction in the price of imports relative to exports) for the United States by shifting some of the tariff burden onto foreign producers.

In the most ideal scenario, the foreign producers would reduce their prices to such an extent that the tariff is entirely compensated for. While this would leave the American consumer unaffected, it also would not help the American producers either. The only change would be a (significant) increase in tariff revenues for the government. In reality, however, many producers cannot drop their prices any lower, meaning that the price of imported goods would increase for the American consumer. Even if consumers switch to American-made products they still would be unable to avoid price increases as American producers would use the increased protection of the tariffs to charge a higher price for their products.

The reduced demand for foreign goods might also help narrow the trade deficit that President Trump is eager to close, but this would only be a short-term effect. The promotion of the import-competing sectors will come at the cost of America's exporting industries as parts become more expensive and resources are reoriented to compensate for the lack of imports.

Even at an increased cost to consumers, this scenario might still benefit the US overall, as American producers benefit from increased sales at higher prices, and the government collects tariff revenue from continued imports. This is what economists refer to as the "optimal tariff rate." However, this leaves out two crucial factors. First, America's gain comes at the cost of the rest of the world, who are unlikely to stand by and do nothing. It also ignores the long-term dynamics that the increased costs, reduced market size, and additional uncertainty will have on the economy.

What Is It Good For? ... Absolutely Nothing

The story does not end here. All three affected countries have swiftly responded with retaliatory measures, and Mexico and Canada have also enlisted the help of their citizens in purchasing local products and avoiding American products as much as possible. In the case of Canada, the government has specifically targeted consumption goods that are mainly of American origin and easily identifiable, such as bourbon or motorbikes, and steered clear of adding pressure on goods that are deeply entwined in Canadian producers' supply chains.

> All theories and evidence suggest [the tariffs] will fail to deliver on Trump's promise of the economic rebirth of the country

A key factor to consider when assessing the impact of tariffs is how they disrupt the supply chains of American companies. Higher tariffs force an economy to focus on production processes it is not good at. They will push some producers to source inputs from American firms, often at higher prices or lower quality. Adjusting supply chains—renegotiating contracts, finding new suppliers, and adapting production—takes time and money, adding another layer of inefficiency. On top of that, some American producers may take advantage of reduced competition by raising prices even further. In the end, while a handful of businesses might benefit, these gains would come at the expense of others, ultimately reducing overall competitiveness.

Regarding the trade deficit, retaliation is certain to undo any short-term gain that might be achieved as exports drop off. Moreover, the gap between imports and exports is such that the reduced demand for foreign goods will not be enough to fill this gap. This was demonstrated during the previous trade war with China, which did little to narrow the gap between their trade flows. Added to this, the US dollar operates as a free-floating currency, meaning its value is determined by international market demand. When tariffs reduce US imports, the demand for foreign currencies falls, while the demand for US dollars rises. This dollar appreciation makes American exports more expensive and less competitive globally. Ironically, this could create a feedback loop: while reduced imports might initially narrow the trade deficit, the declining demand for US exports may push the deficit back up.

Some optimists may hope that, in the long term, these tariffs will fulfil President Trump's promise of reviving American manufacturing. He has often blamed China and this is not entirely without reason: it has been estimated that the increased demand for Chinese goods and the relocation of manufacturing to China may have cost the US around 2 million jobs between 1999 and 2011. To combat this, the president has suggested setting up tax incentives for firms to reshore production and hire local workers. However, this is unlikely to reverse the decrease in manufacturing jobs. Domestic production cannot fully meet the demand for Chinese goods, even with tariffs in place. Additionally, many low-skilled manufacturing jobs are now threatened by automation, as robots are often more cost-effective than human labour. Reshoring may further accelerate automation as firms may seek cheaper alternatives to local labour, leaving American workers without the expected benefits. It is also worth mentioning that, during his first term, the trade war with China led to a net negative impact on US employment despite compensatory subsidies. Multiple studies have confirmed that these measures not only failed to boost employment but also harmed overall US welfare.

In many ways, this trade war feels like a eulogy for the US-Mexico-Canada Agreement (CUSMA), the free trade pact that President Trump forced into renegotiation during his previous term. Originally set for revision talks in 2026, the treaty now seems unlikely to survive that long. If Brexit has taught us anything, it is that dismantling a major trade agreement will hurt all three member countries. The uncertainty surrounding CUSMA's future is already casting a shadow over cross-border investment in the region. Mexico and Canada, whose economies are deeply intertwined with US supply chains, stand to lose significantly from any rollback in trade cooperation. But the consequences extend beyond North America—President Trump's aggressive trade policies threaten not only regional agreements but also the broader multilateral system. China has formally filed a complaint with the World Trade Organization (WTO) against the US, though this move is more symbolic than substantive. The WTO's appellate body has been paralysed since 2018 due to the US's refusal to appoint new judges, effectively rendering the dispute settlement system toothless. The Trump administration has shown a strong willingness to disengage from international organisations that do not align with its views, as evidenced by its withdrawal from the World Health Organization at the height of a global health crisis. This pattern signals a broader rejection of multilateralism in favour of unilateral action, undermining institutions designed to manage global economic relations.

> If most economic analyses point to a negative impact of this trade war, what does Trump expect to gain? Perhaps the real objective is not economic at all, but political

If most economic analyses point to a negative impact of this trade war, what does President Trump expect to gain? His trade policies fit neatly within a populist, anti-globalisation framework, even if they defy economic logic, suggesting the move may be more political than economic. In any case, a trade war is never without suffering, and this move could see the people of America, and his political support, both suffer as a result.

EDITORIAL INFORMATION

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Publisher: United Nations University Institute on Comparative Regional Integration Studies (UNU-CRIS), Bruges, Belgium