HSBC Global Research

1 June 2022

UK tariffs and inflation

Could cutting duties curb rising prices?

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- The UK Government is considering reducing tariffs to help ease inflationary pressures…
- …but we think this would have a limited impact as UK tariffs are already low by global standards...
- …and our estimates suggest that removing all tariffs may only temper UK inflation by 0.4ppts at most

Shanella Rajanayagam
Trade Economist
HSBC Bank plc

Chris Hare
Senior Economist
HSBC Bank plc

How to tame inflation

As living costs in the UK continue to surge, the UK government is coming under increasing pressure to take steps to help curb rising prices. One such proposal that has been floated recently is for the UK to temporarily cut tariffs – perhaps for six or 12 months. Proponents of the idea in government see little point in maintaining tariffs on goods not produced in the UK that subsequently feed into retail costs, while opponents, including International Trade Secretary Anne-Marie Trevelyan, are concerned that reducing tariffs would do little to ease living costs while reducing the UK's leverage in trade negotiations with other countries.

A limited impact

We too think that cutting UK tariffs would do little to help ease inflationary pressures for three key reasons: 1) UK tariffs are already relatively low by global standards (e.g. 5.7% average non-preferential tariff compared with 7.2% in the EU), 2) Over 66% of UK imports are already eligible to enter under reduced or zero duty via trade deals or developing country preferences, including over two-thirds of UK food imports that can enter tariff-free, and 3) a one-off cut to (already low) tariffs will do little to target the main drivers of UK inflation (e.g. energy and food prices) which are mainly due to external factors such as the COVID-19 pandemic and the war in Ukraine.

Estimating the effect on prices

According to our estimates, unilaterally cutting all UK tariffs could help to lower UK consumer prices by 0.4-0.5ppts, assuming that importers pass on all the tariff savings to consumers. This is in line with UK government estimates that suggest tariffs make up just 0.4% of the cost of living.

Although the bulk of the reduction in prices from cutting customs duties is likely to come via food and drink, it is not guaranteed that importers would pass on the cost savings entirely as they may choose to support their profit margins instead. And even if there is complete pass-through, it would only make a small dent in the UK's broader inflation squeeze and would be far less impactful than the Chancellor's fiscal package announced last week, in our view.

So while the proposal sounds reasonable in theory, we think cutting tariffs would do little to help curb soaring prices, in practice.

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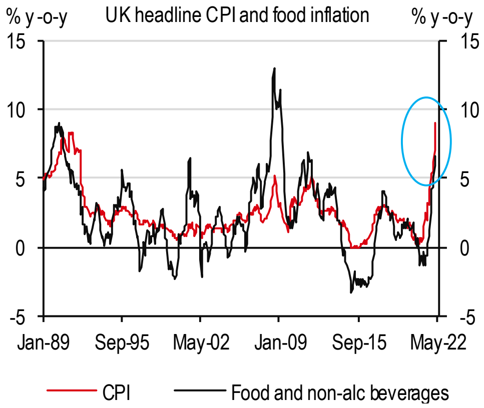
Tariffs and taming inflation

What's being discussed?

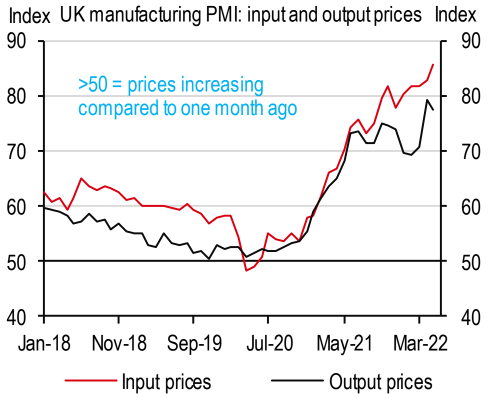
With UK headline inflation hitting a 40-year high of 9% y-o-y in April 2022 and food prices rising by 6.7% over the same period, the UK government is coming under increasing pressure to take steps to help ease the cost of living crisis. Just last week Chancellor Rishi Sunak announced GBP15bn worth of measures to help households, partially funded by a GBP5bn windfall tax on the profits of oil and gas companies.

1. UK inflation is soaring…



Source: Refinitiv Datastream

2. …impacting input costs for businesses



Source: S&P Global

The UK government is looking at whether tariff cuts could help tame inflation

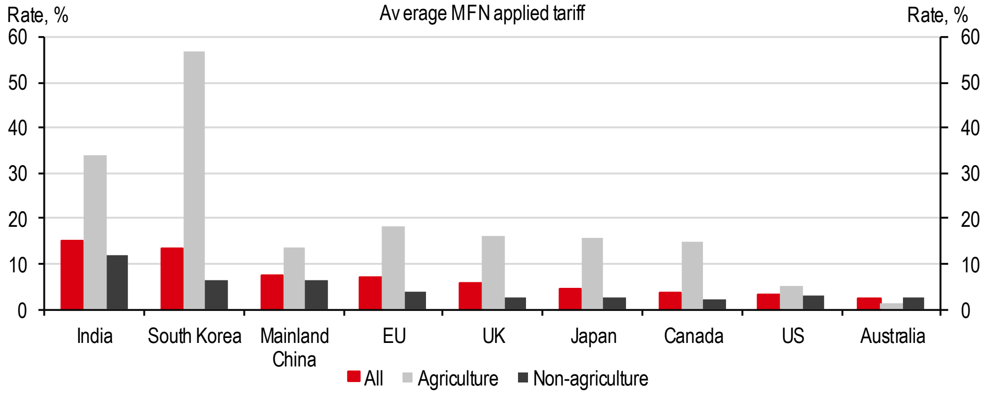
Another proposal that has been floated recently that could potentially help to curb soaring prices, is for the UK to temporarily cut customs duties. According to Politico, The UK Government recently tasked the UK Department for International Trade to assess the impact of unilaterally reducing tariffs.Theory vs. practice

So could reducing tariffs make a dent in inflation? In theory, the plan sounds reasonable. Cutting tariffs should help to reduce prices paid by importers, retailers and consumers by the same amount, provided any duty reductions at the border are fully passed through and notwithstanding any changes in other costs of production (e.g. logistics, processing costs and so on). However, things are unlikely to be so clear cut in practice, and we think that cutting UK tariffs will do little to help ease inflationary pressures for three key reasons.

But UK tariffs are already low by global standards…

Firstly, UK tariffs are already relatively low by global standards (Chart 3). For example, under the UK's post-Brexit tariff schedule, average UK non-preferential tariffs are 5.7%, which compares with 7.2% in the EU and 3.4% in the US. Even with the UK maintaining tariffs on certain sensitive goods such as beef and cars, in part to protect domestic industry interests, nearly half (47%) of all tariff lines in the UK's tariff schedule do not attract any duties, including oil and gas but also products such as phones and computers.

3. UK tariffs are already relatively low by global standards…

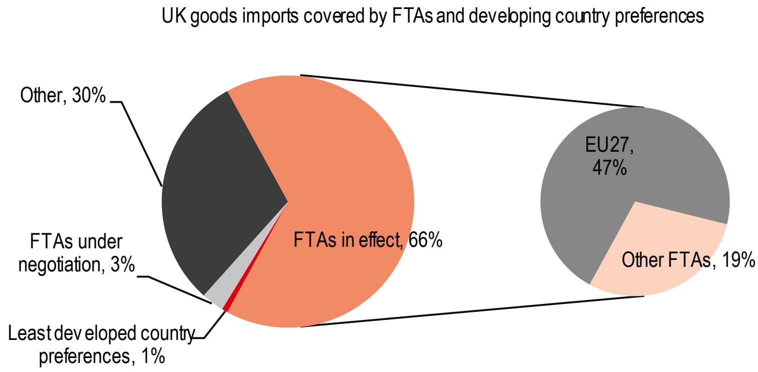


Source: WTO, UK Government. Note: EU and UK average tariffs taken from the UK Government's response to its tariff consultation, where non-agriculture data reflects industrial goods.

…the bulk of UK imports are eligible for tariff preferences…

Secondly, over two-thirds of UK imports are already eligible to enter tariff-free or at reduced duty thanks to free trade deals and developing country preferences (Chart 4). In fact, the UKTPO estimates that around 66% of UK food imports are sourced from the EU (or nearly 30% of total food consumed in the UK), all of which are eligible to enter duty-free under the UK-EU trade deal provided rules of origin are met. A further 1.8% of UK food imports are sourced tariff-free from developing countries, while around 9.6% enter MFN duty-free.

4. …and a significant portion of UK imports are eligible to enter under FTA or developing country preferences…

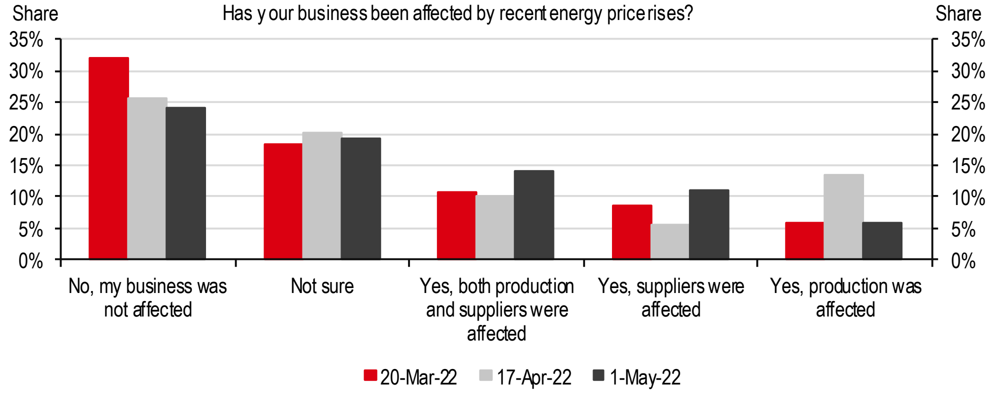


Source: ONS, UK Government, HSBC. Note: A greater share of UK imports may be eligible to enter duty-free under other developing country preferences, such as the General Framework and Enhanced Framework, which cover certain imported products. We have shown data for imports from economies that are covered by the Least Developed Countries Framework only as all imports from these markets (except arms and ammunition) are entitled to tariff-free access. Trade data for 2021.

…and soaring prices are more due to external factors

Thirdly, the surge in UK headline inflation has been driven by factors such as rising commodity prices (e.g. energy, grains) and input shortages caused by supply chain disruptions during the pandemic, rather than tariff increases (see latest *Commodities Digest: Food crunch continues*, 13 May 2022). Indeed, nearly one-third of British businesses reported that their production and/or suppliers were affected by increases in energy prices in late April-early May, up from 29% in early April, while over 40% of manufacturing businesses passed on recent price rises to consumers. Therefore, we believe a one-off cut to (already low) tariffs will do little to target the main drivers of inflation which are more a result of external factors such as the COVID-19 pandemic and the war in Ukraine.

5. Rising energy costs are impacting UK businesses…



Source: ONS. Note: All businesses.

What do businesses think?

Businesses in protected industries could come under pressure…

Removing tariffs may also impact UK businesses in protected industries (e.g. agriculture) should consumers choose to purchase cheaper foreign products that become more freely available in the UK, rather than locally produced goods. The National Farmers Union is opposed to tariff cuts for this reason (Politico, 18 May 2022).

The UK Food and Drink Federation also believe that unilateral tariff cuts would do little to address the cost of living squeeze and could damage the UK's food security, while both the British Retail Consortium and the Federation of Small Businesses think the plan would have a minimal impact on consumer prices (Politico, 18 May 2022).

Other implications

Cutting UK tariffs could also lead to a loss of tax revenue for the UK government and may affect the UK's negotiating leverage in trade talks currently underway (e.g. with India). However, the UKTPO estimates that tariff revenue on food is no more than GBP500m (0.1% of total tax receipts), and the UK could get around the negotiating leverage issue by noting that any reductions are likely to be temporary (i.e. for just six or 12 months). Proponents have also suggested that lower or zero tariffs could encourage trade negotiating partners to quickly sign bilateral trade deals with the UK in order to lock-in the reduced duty rates before tariffs are hiked again. However, unilateral tariff cuts could impact some developing country exporters that send products to the UK under existing preferences by exposing them to competition from exporters in other markets.

…and there is a risk that inflation could rise again once duties are re-imposed

If the tariff cuts do go ahead, much will depend on how long the reduced or zero duties remain in place. Too short a period of time and the cuts may not be very effective as it takes time for trade flows to reorient and for producers in other economies to scale up or redirect their trade. On the other hand, trading partners may become used to the unilateral duty cuts should the reductions remain in place for a longer period of time, rendering the UK's negotiating leverage less useful in trade talks. There is also a risk that trade flows could be disrupted and inflation may be driven up again once the tariffs are reinstated.

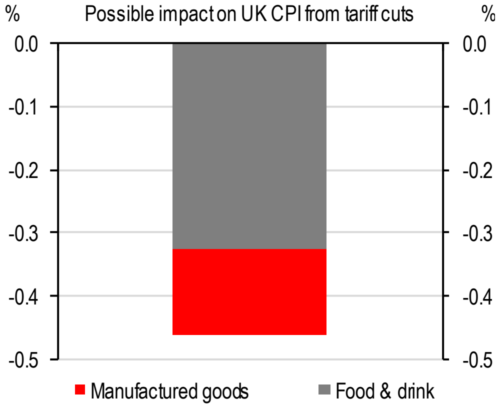
Quantifying the inflation impact

So how much might the UK government's mooted tariff cuts actually lower inflation? As a starting point, UK Trade Secretary Anne-Marie Trevelyan suggested that tariffs are worth 0.4% of the cost of living.

Tariff cuts would lower the UK consumer price level by just 0.4-0.5ppts, on our estimates

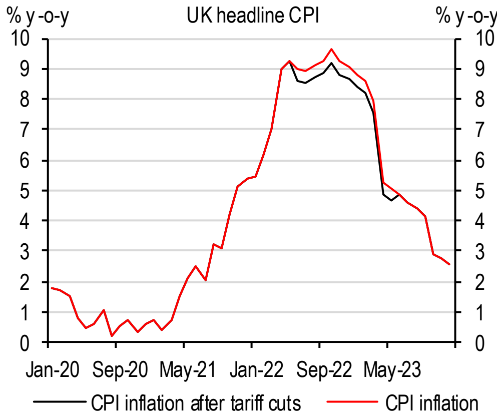
If we then assume that importers, who are currently paying tariffs, pass all the savings onto consumers, we estimate that would lower the UK consumer price level by 0.4-0.5ppts, in line with the UK government's estimate. And given the fact that tariffs on agricultural products and processed food are high, and the UK's consumption is fairly import intensive, most of the reduction in prices would come via food and drink (Chart 6).

6. Tariff cuts would mainly have an impact on food and drink prices…



Source: UK Department for Trade, ONS, HSBC calculations

7. …but the impact would look small in the face of extremely high inflation



Source: ONS, HSBC forecasts

Combatting the cost-of-living squeeze?

Granted, a 0.4% reduction in the price of the typical consumer basket won't be entirely unwelcome for UK households. But this is based on an assumption that importing businesses pass on all the cost savings quickly, so the inflation impact comes through for around a year – but they may instead choose to take the gain on their profit margins. And even if it's all passed through, it would only make a small dent in the UK's broader inflation squeeze, and would pale in comparison to the impact of the recently announced fiscal measures, in our view.

In other words, tariff cuts would do little to tame soaring inflation.

Disclosure appendix

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