From trade wars to war games: Weaponising US dominance

CAPITAL CONTOURS

BY RAY CHOY

The long-anticipated snapback date of July 9 for reciprocal tariffs is fast approaching, setting the stage for a new round of high-stakes trade negotiations. This marks the end of the grace period suspending US reciprocal tariffs, and the automatic mechanism is poised to reimpose duties of as high as 50% on imports. Meanwhile, the baseline 10% tariff will remain in place across the board, while average tariffs are expected to settle in the high teens over time.

The confluence of events surrounding the US' Operation Midnight Hammer offensive on Iran on June 22, ahead of its Independence Day on July 4 and the July 9 date for the renewal of tariff negotiations, converge towards expanding US presence on both the trade and geopolitical wars, alongside reinforcing President Donald Trump's political capital in the US. With the operation, Trump has gained an advantage on the geopolitical balance of power in the Middle East, while fanning the embers for increased defence expenditure by North Atlantic Treaty Organization (Nato). Additionally, Iran, often invoked as a symbolic villain in American political discourse, appears to have been coerced into serving as a convenient pawn in advancing US economic and geopolitical goals, despite its limited agency in the Israel-Iran conflict. While the Russia-Ukraine conflict has for some time set the stage, the Israel-Iran conflict may very well have been the tipping point to galvanise a change in Nato's policy priorities.

Regardless of Nato's subsequent actions, recent developments have nonetheless pressured Germany to raise its defence spending to 3.5% of GDP by 2029, up from the long-standing target of 2%. More broadly, at the June 2025 Hague Summit, Nato members agreed to increase defence spending to 5% of GDP by 2035, a significant rise from the 2% threshold set at the Nato Wales Summit in 2014. Both internally and externally, it is not politically viable for Europe to remain a passive observer amid mounting geopolitical tensions, particularly given that the US has weaponised tariff negotiations and also remains Nato's most influential voice. In effect, Europe will now shoulder more of the defence budget, potentially in exchange for improved terms in ongoing tariff negotiations, assuming goodwill reciprocity.

Consequently, the Israel-Iran conflict serves to benefit the US as the largest defence contractor for Nato, with Germany leading as the largest European contributor. Regardless of the imposed tariffs, a new trade deal had already been struck for the US, building upon Nato defence spending, which is estimated at more than 15% of the US total trade value in goods as at 2024. Notably, Stockholm International Peace Research Institute (SIPRI) data shows that the US is the world's largest arms exporter, accounting for over 40% of global arms exports, with a growing share directed toward Europe. Beyond the boost to US exports, Europe is set to assume a significantly larger share of Nato expenditure over time, with its defence spending projected to outpace the growth of US military spending over the next decade. While US contributions to Nato will continue to rise, the acceleration in European defence spending is comparatively sharper. Although the proposed tax cuts under Trump's "One Big Beautiful Bill" are estimated to reduce federal revenue by US$4.7 trillion to US$4.8 trillion over the next decade, this is partly offset by the rise in Nato's defence spending. Nato's defence spending is projected to rise by at least an additional US$1.5 trillion over the same period of the US tax cuts, of which a significant amount, estimated at two-thirds, would be attributable to US defence exports and industry.

While some believe in game theory's Cournot equilibria, whereby repeated retaliations are possible responses to reinforce mutual discipline, a leader-follower Stackelberg equilibrium is more applicable in the current scenario since the non-US actors' ability to retaliate is eroded by the: (i) lopsided balance of geopolitical power in favour of the US; (ii) vast difference in economic size between retaliators and the US; (iii) fragmentation of retaliatory actions due to coordination complexities and information asymmetries among groups of smaller countries compared with the US as a single entity; and (iv) first mover advantage of the US in defining the global imposition of tariffs. The one-sidedness of this strategic game may be further manoeuvred to the benefit of the US if it forms bilateral deals with its largest partners.

In Europe, geopolitical conflicts have served as a rallying point and, similarly, Japan is likely to align closely with the US amid growing security concerns over China, Russia and North Korea. This consolidates a substantial share of global economic power within a US-led economic caucus comprising the US, Europe and Japan. Furthermore, as the US forms a partnership with global economic powers, the potential impact of adversaries dumping US financial securities is reduced. Japan is the largest holder of US Treasuries, while the UK has recently overtaken China as the second largest holder, reinforcing the historical UK-US transatlantic relationship, sustaining the asymmetric global order.

The conventional narrative questions Trump's policies, although the analysis is better framed through a cost-benefit assessment, rather than a linear understanding of the impact on economic variables. To begin, while inflation following tariffs is a cost, it is manageable — the US core Consumer Price Index (CPI) is expected to rise by 0.2%-0.3% assuming the 10% baseline tariff remains, or rise by at most an additional 1% in the event the reciprocal tariffs average 20%. Similarly, US GDP growth could be affected, at an estimated cost of 1%, which is not disastrous considering that recessions usually see GDP shifts of -2% to -3%. Without tariffs, US GDP growth would have already exceeded 2%. Therefore, accounting for the economic cost of tariffs implies, at worst, a mild contraction. Furthermore, this has yet to incorporate the long-term accretion of tariff dollars and Nato spending as mentioned above. Therefore, while retaliatory rhetoric may yield political gains for some, effective retaliation against the US requires imposing a more sizeable economic cost. A case in point was Canada's U-turn on its retaliation through a digital service tax. As observed, additional impediments to retaliation are the evident lack of a coordinated response needed to overturn the current leader-follower Stackelberg equilibrium and the increasing dominance of bilateralism over multilateralism. While trade protectionism imposes costs on global commerce, the broader pursuit of global free trade is too expansive and misaligned with Trump's strategic priorities over his visible time horizon.

Consequently, the 10% baseline tariff is likely to remain after July 9, with potential for higher rates on "miscreants". Conversely, there is potential for last-minute deals to be made with smaller reciprocal tariffs to limit the fallout on economies and financial markets while reserving tariff ammunition for future policy leverage. Looking forward, US politicians will see it most strategic to maintain tariffs until 2026, before cutting them as the US election cycle begins in 2027 for an economic and political fillip. ■

Dr Ray Choy is chief economist at MARC Ratings. The views in this article are his own and may not necessarily represent the views of the company.