Europe in the crosshairs of US trade policy

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Key points

- The markets must consider US tariff policy to be at the heart of a strategy that combines commercial objectives with industrial, social, and purely political ones.
- Tariff hikes are by nature 'stagflationary', subtracting from growth and adding to inflation.
- A hostile US trade policy would force the eurozone to find alternative trade routes into the United States and to develop new markets.
- The European commission is expected to respond gradually to higher US tariffs.
- European growth could be severely hurt if US implements a 10% tariff hike globally.
- Only the European central bank has room to maneuver to balance downside and growth.

Tariffs as the new focus of US economic policy

At the beginning of the year, financial markets had favoured a scenario of limited tariff increases, betting on a threat rather than on an economic reality. The first decisions taken by the new US president regarding Canada, Mexico and China reignited the threat of a trade war. This forced markets to put tariffs back at the centre of US economic policy, as announcements on sectors and countries have followed one another on a weekly basis.

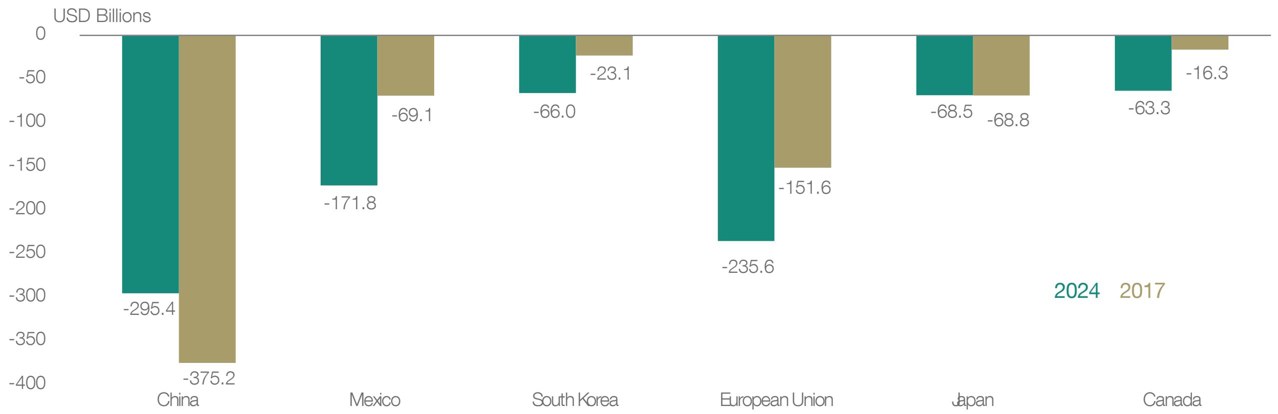
The markets must consider that US tariff policy is at the heart of a strategy that combines commercial and transactional objectives ('let's make a deal') with industrial, social, and purely political ones. The creation of a tariff collection service, allegedly to finance domestic tax cuts, proves that this tariff policy is here to stay and has become part of the economic and political landscape.

Markets will be watching closely to see how this tariff policy could affect the growth-inflation relationship in the US over the next few years. The desire to push US growth to its potential, or even beyond, combined with sharp tariff hikes, could damage the outlook through unwanted inflation from higher import and production costs, as well as through the uncertainty created for the manufacturing sector.

Tariffs hikes are by nature 'stagflationary'. They subtract from growth and add to inflation, with no real winner at global level in the medium term. Inflation expectations are therefore likely to rise, reflecting fears that inflation will be more persistent than expected. Inflation could be driven by costs rather than excess demand, which would weigh on corporate margins. The Fed would then be forced to reconsider its strategy of a gradual return to a 'neutral' monetary policy and would remain restrictive above the neutral rate. This explains the volatility we have seen in both long-term and 2-year rates in recent weeks. The US policy view is that additional costs or distortions in supply should be more than offset by increased deregulation and tax cuts on corporate profits.

Tariff policy is a factor of uncertainty and fragmentation of global activity. It exacerbates the imbalances it is supposed to correct by redistributing growth between sectors and countries. In the short term, this rebalancing will be to the advantage of the United States to the detriment of its trading partners, but in the medium term the balance will not be positive, even for the United States.

US TRADE DEFICIT WITH MAIN COUNTRIES



Source: US Census Bureau

Past performance is not a guide to current or future results. Any forecast, projection or target, where provided, is indicative only and is not guaranteed in any way.

Pressure will also mount on central banks outside the US to accelerate or intensify their interest rate cuts to counter the risks of a contraction in trade and exports while currencies weaken.

The tariff policy envisaged by the new US administration does not seem to be able to correct the distortions that have been created in world trade and the global economy after decades of globalisation and free trade. In an almost caricatured way, the United States dominates the world through the strength of their consumption and their technology, while China dominates the industrial world through its production, some of which is heavily in surplus. A policy of increased tariffs or protectionism will only be able to partially correct and influence these strong specialisations between countries, and the expected movement towards relocation is likely to remain limited.

Moreover, the debate focuses on trade and the flow of goods, but ignores the fields of services and new technologies, which dominate the economic cycle and in which the United States wants to maintain a clear advantage.

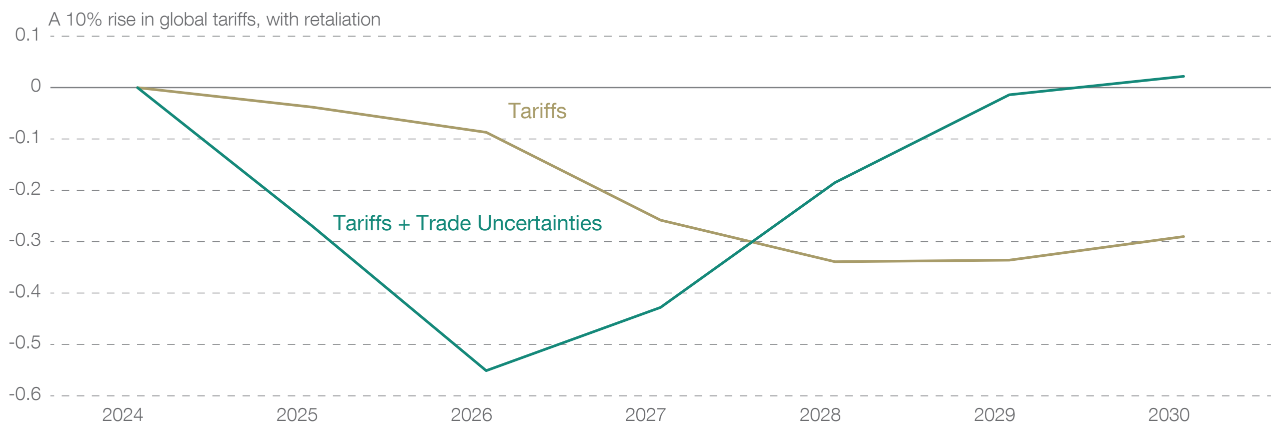
United States: targeting Europe and its vulnerabilities

In 2024, the eurozone had a trade surplus of almost USD 250 billion with the United States and it constitutes one of its largest trading partners (accounting for 15% of US imports). The surplus is generated by the following sectors: machinery, capital goods, pharmaceuticals, chemicals, and automobiles. Since 2019, trade between the United States and the euro area has increased by more than 10%, thanks in particular to oil and manufacturing. The countries with the largest surpluses with the US are Germany and Italy, followed to a lesser extent by Ireland, France, and Spain.

From the US point of view, the eurozone is seen as a trade distorter, practicing unfair regulation and getting a free ride in terms of military spending, as it uses American protection at the lowest cost.

A 10% increase in tariffs on European imports to the United States, with a tariff response from the euro area, would have a potential negative impact on European growth of almost 1 percentage point (-0.7 pp). Depending on the size of Europe's response and the US tariffs, the impact on its growth would vary between -0.3 pp and -0.7 pp (IMF and Brokers studies). However, the US could opt for targeted sectoral or country discrimination rather than a flat 10% tariff on traded goods.

EUROZONE GDP IMPACT FROM TRADE POLICY



Source: IMF - Global prospects and policies Oct. 2024

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For example, the recent imposition of tariffs on aluminium and steel (25%) remains more symbolic than economic for the eurozone, as these sectors represent only 0.05% of eurozone GDP. The impact on European growth appears to be negligible, and the move seems to be directed more against Canada and certain Asian countries. The inclusion of specific tariffs on cars (25%) would have a more significant but limited overall impact on the euro area (0.25% of euro area GDP).

The United States could adopt an approach which targets specific sectors, with some labelled as strategic or critical sectors. In addition to automobiles, these sectors would include oil, pharmaceuticals, semiconductors, metals, and chemicals. Tariff increases of around 10% on these sectors could be permanent, with the aim of bringing production back to the United States. The countries most affected by these increases would again be Canada and Mexico, but also China, Asia, Germany, Switzerland, and Sweden. It should be noted, however, that even a 10% increase in tariffs would not compensate for the difference in production costs between the United States and the rest of the world in these sectors (a difference of around 40%), and that tariffs alone cannot constitute or replace an industrial policy in favour of these sectors.

These differentiated approaches by sector or country could limit the ability of the eurozone, whose trade and customs policy is the responsibility of the European Commission, to react. This US policy would then aim to divide the eurozone and lead countries into bilateral negotiations outside the Community framework; Germany and Italy, unlike France, could be tempted by such a reaction.

In addition, US negotiations with the eurozone could go beyond trade to include a range of areas such as geostrategy in Europe (peace with Russia, shared roles in the reconstruction of Ukraine and Eastern Europe, European defence), trade and strategic relations with China, and the regulation of new digital sectors.

Gradual eurozone responses expected

As in 2018, the eurozone's reactions to the increase in US tariffs could be gradual, so as not to trigger a full-blown trade war. An appeal to the World Trade Organization (WTO) would probably be launched to recall the international trade framework, which will take years to develop and which the United States wants to escape.

In 2018, the eurozone responded by raising tariffs on certain US products (steel, agriculture and consumer goods), but the amounts in value only represented half of the products taxed by the United States. The same graduated response could be used by the European Commission, which has already announced that it is ready to consider larger purchases of LNG (long-term contracts) and additional arms purchases (raising arms spending above the 2% of gross domestic product (GDP) as required by the United States within NATO); in addition, the Commission could align itself with US policy towards China and increase its sanctions based on anti-dumping rules against Chinese products.

However, as part of a wider retaliation, the European Commission could also target services, particularly digital companies, and social networks, which are already the subject of tensions between the two continents. The eurozone has a services deficit of around EUR 150 billion (0.8% of the zone's GDP). In response to tariff hikes on goods, the Commission could act on services based on the Anti-Coercion Instrument (ACI) created in 2023, which allows it to react to tariffs and restrictions on certain services and intellectual property rights. However, in order to use the ACI, the Commission has to prove that tariffs have caused damage to the industry and a vote has to be held to approve its use (with 15 out of 27 countries agreeing).

A hostile US trade policy would force the euro area to find alternative trade routes into the United States, to develop new markets (such as the free trade agreement with Mercosur) and to find local substitutes or suppliers for taxed products.

The free trade policy that has been in place in the euro area for several years is now being undermined by the return of US protectionism and the difficulties of exporting to China, as well as the rejection of new free trade agreements within the euro area (agriculture, small-scale industry). The Commission and several member states are taking steps to give priority to the European internal market by reducing regulation, stimulating domestic demand, and strengthening European technology, but this seems late compared with other economic areas and the financial resources are not proportionate to the political ambitions.

Policy response: only the ECB has room for manoeuvre

Fiscal policy in the eurozone has begun to return to a certain degree of budgetary rigour, with the planned but very slow reduction in budget deficits at both regional and national levels, in parallel with the downward trend in public debt. Europe is therefore not able to respond quickly to a trade war with new targeted budgetary supports. There is also no consensus on the mobilisation of new budgetary resources, and there is no unanimity in the euro area on the renewal of European Recovery Fund-type measures. Moreover, the Commission is restricting and tightly controlling subsidies to specific sectors, which also limits possible responses at national level. Conversely, there is a consensus at European level to increase defence spending (a low GDP growth multiplier) and the European budget already includes funds for new technologies. Moreover, the EUR 750–800 billion of funding for 2030 envisaged in the new European strategy (Euro Compass) will require the use of private savings and funds rather than European public funds.

Only the European Central Bank (ECB) seems capable of easing cyclical pressures by continuing to cut interest rates. The trade war poses more of a risk to eurozone growth than inflationary risks, even if the eurozone reacts by raising its tariffs. The price drift from across-the-board tariff hikes would not exceed 0.05 pp on eurozone inflation, which remains limited. Moreover, a decline in external and domestic demand would have an impact on employment in the euro area. After a period of observing the specific effects of trade policy and in the light of a further deterioration in the economic situation, the ECB could decide to lower its key rates below the 2% expected in the baseline scenario and extend the cut until 2026. If recession returns, the ECB's new target could be around 1%, or even lower if the demand shock is severe. The difficulty for the ECB would be to conduct a monetary policy that covers the different trade shocks from one country to another within the eurozone which would exacerbate the asymmetry that already exists between countries.

Uncertainty is poison for the business cycle

Pending further details on the products affected by the US tariff increases and the reactions of the various states concerned, US trade policy has significantly increased uncertainty in the global economy and has also reduced visibility. More than protectionism, uncertainty is poison for the economic cycle because it blocks purchasing and investment decisions. As International Monetary Fund (IMF) studies underline, uncertainty can double the negative impact on the activity of simple trade restrictions. Negotiations and details on trade barriers will have to follow hot on the heels of announcements on tariffs to avoid having too big an impact on global, European and US growth.

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Glossary

Anti-coercion instrument (ACI)

A legislative tool designed to counter economic coercion by foreign entities, allowing the EU to impose trade restrictions or deploy countermeasures.

Euro Compass

A strategic initiative by the European Commission aimed at guiding the European Union's economic policies. It serves as a response to growing global competition and economic challenges.

Gross domestic product (GDP)

The total value of all goods and services produced within a country over a specific period, serving as a key indicator of economic performance.

LNG (long-term contracts)

Agreements for the supply of liquefied natural gas (LNG) over extended periods, ensuring price stability and energy security.

Neutral rate

The theoretical interest rate at which monetary policy is neither stimulative nor restrictive, balancing economic growth and inflation.

Stagflation

A rare economic condition characterised by stagnant growth, high unemployment, and persistent inflation, making traditional monetary policy responses challenging.

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