Special Report

Europe – Trade wars are bad and there will be losers if tariffs are raised on car exports

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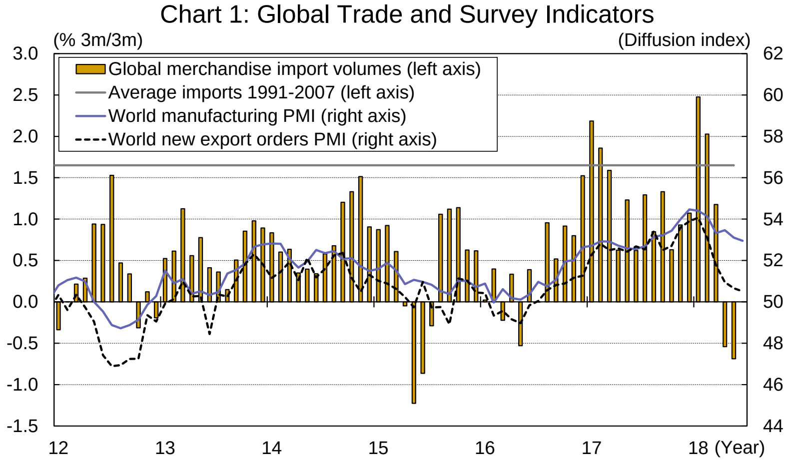
1. Introduction

After announcing tariffs on steel and aluminium imports to the US, Donald Trump tweeted on 2 March that "*trade wars are good, and easy to win*". Despite this, most observers continued to expect a small increase in protectionism rather than a full-blown global trade war. The short-lived steel tariffs under Bush in 2002 and Obama's tariffs on Chinese tyres were references; the global impact of these was negligible. However, Trump seems determined to go much further, and both the EU and China have been committed to reciprocation. Since March, a series of tariffs and counter-tariffs have raised the stakes. For Europe, tensions eased somewhat after Trump and Juncker, the president of the European Commission, declared a ceasefire on 25 July. But in the absence of any meaningful commitments we remain cautious – the threat of US tariffs on car imports has not gone away.

Chart 1 shows how global trade had looked increasingly healthy from mid-2016. But after peaking in January this year, growth in world import volumes has gone into reverse and survey data has weakened further in recent months. In this context, we focus on how the European economy could be affected by the announced tariffs, and consider the risk of further escalation.

Chart 1: Global Trade and Survey Indicators



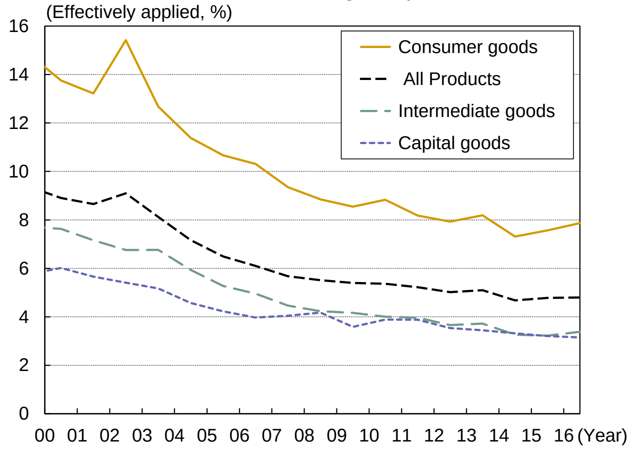
Source: IHS Markit, Netherlands Bureau for Economic Policy Analysis, MUFG Bank Economic Research Office

2. Rising protectionism

Global leaders have generally resisted protectionism since the Global Financial Crisis (GFC). Average import tariffs have been decreasing globally for more than a decade and are now around 5% (Chart 2) while the average tariffs between the EU and US are even lower (under 3%). Most economists would agree that this is positive as trade between two parties is mutually beneficial and supports economic growth, job creation and productivity.

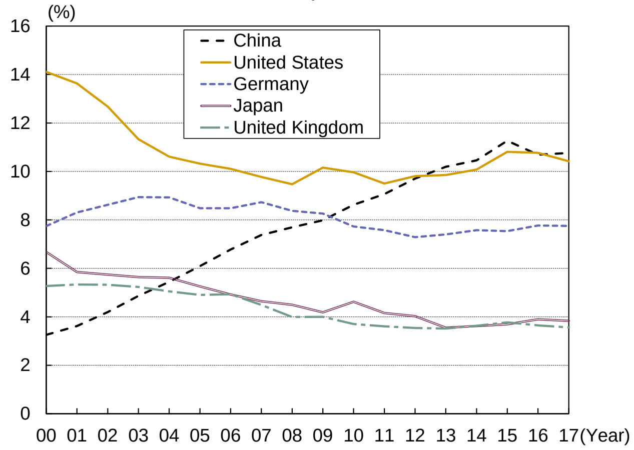
Changes in trade flows can provoke political challenges, however. The share of EM economies in global trade is increasing, led by China which has seen its share of global exports increase rapidly from 3.5% in 2000 to over 10% by 2017. Meanwhile, the US and Germany have had relatively steady shares of about 10% and 8% respectively over the last decade (Chart 3).

Chart 2: Global Average Import Tariffs



Source: World Bank, MUFG Bank Economic Research Office

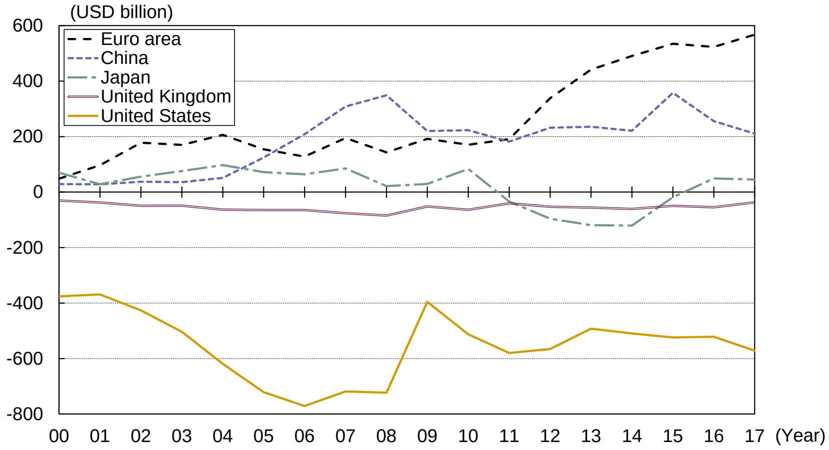
Chart 3: Share of Global Exports of Goods and Services



Source: OECD, MUFG Bank Economic Research Office

Despite having a tenth of global exports in an increasingly globalised world, Donald Trump, the US president, takes a more mercantilist view. He worries about the persistent US trade deficit (Chart 4). This seems to resonate with his political base and it is perhaps no coincidence that he has started to focus on trade ahead of the US midterm elections in November. We also note that the US trade deficit had been widening in the wake of the fiscal stimulus measures.

Chart 4: Trade Balances (Goods and Services)



Source: OECD, MUFG Bank Economic Research Office

Table 1 shows a timeline of rising trade tensions in 2018. The first shot was fired in January when Trump approved import tariffs on washing machines and solar panels to the US. This was followed in March with tariffs of 25% on steel and 10% on aluminium, justified on the grounds of national security. Temporary exemptions were granted to the EU, Canada and Mexico but ensuing negotiations failed to find a solution and the tariffs became applicable to the originally exempt economies on 1 June.

The EU immediately imposed retaliatory tariffs on politically sensitive consumer goods such as bourbon, jeans and motorcycles (which are produced in traditionally Republican-voting states). Meanwhile, the US also pushed on with further tariffs on imports from China. These were swiftly met by Chinese countermeasures.

Table 1: Timeline of rising trade tensions in 2018

22 January	Trump approves import tariffs on washing machines and solar panels to the US.
8 March	The US declares tariffs on steel (25%) and aluminium (10%) from March 23, with some countries exempt.
16 March	The EU publishes a list of possible retaliatory measures.
22 March	Trump announces “strong actions to address China’s unfair trade”.
26 March	The EU launches a safeguard investigation to prevent trade diversion of steel products into the EU.
3 April	The US publishes a list of products that could be faced with a 25% tariff when imported from China.
5 April	China announces a list of products which could be hit with retaliatory tariffs.
22 May	China reduces tariffs on imported cars from 25% to 15%.
29 May	The US announces that it will continue with 25% tariffs on $50 billion worth of Chinese imports.
1 June	The 25% steel tariff and 10% aluminium tariff start to apply for imports from the EU, Canada and Mexico.
8-9 June	A turbulent G7 summit sees Trump clash with Canadian PM Trudeau.
14 June	The EU approves retaliatory action against the US tariffs on steel and aluminium.
15 June	The US publishes a list of imported goods from China that will be subject to further tariffs of 25%. China indicates that countermeasures will be introduced.
22 June	EU tariffs of 25% come into force on goods such as motorcycles, bourbon, orange juice and peanut butter.
6 July	Further US tariffs on imports from China start to apply. China imposes retaliatory tariffs.
12 July	The US proposes tariffs on a further €200 billion of Chinese imports.
25 July	Trump promises Juncker that he will “hold off on further tariffs”. The European Commission says it will “work together toward zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods” and “resolve the steel and aluminium tariff issues and retaliatory tariffs”.

Source: Bloomberg, Reuters, MUFG Bank Economic Research Office

So far, most of Trump’s attention appears to be on China’s trade surplus with the US. But there is also a significant imbalance with Europe. Eurostat estimates the surplus was 119 billion EUR (134 billion USD) in 2017. Germany alone has a surplus in goods trade of 66 billion EUR (75 billion USD), a large part (32%) of which is accounted by its balance in automobiles and parts.

In the rest of this report we consider how the already-announced tariffs will affect the European economy as well as the risks of further measures which could target the European surplus.

3. Effects

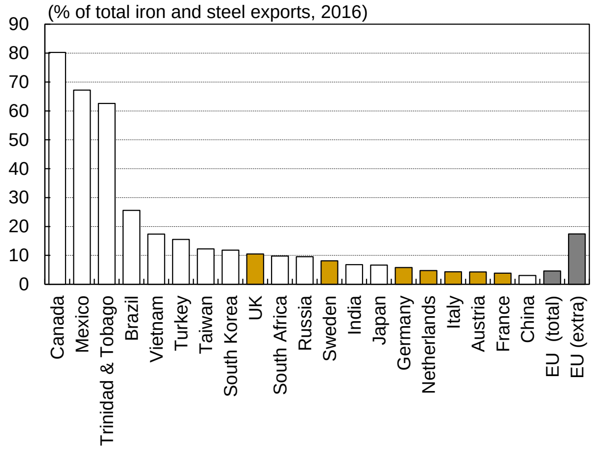
(1) Steel and Aluminium

First we consider the effects of the already-imposed tariffs. The 25% steel tariff and 10% aluminium tariff on imports to the US started to apply on 1 June. These measures affect EU exports worth 6.4 billion EUR in 2017 (just 0.04% of GDP). The EU is also less exposed than other economies. 17.4% of *extra*-EU exports of steel went to the US in 2016, or just 4.6% when taking into account internal EU trade as well (Chart 5). This compares to 80% of total steel exports for Canada and almost 70% for Mexico. The EU is even less exposed in aluminium; 3% of total exports and 17% of extra-EU exports went to the US in 2017.

The risk of trade diversion is perhaps more important. Exports originally intended for the US may now be diverted to the EU and harm domestic producers. The EU has launched an investigation into possible safeguard measures which is due to be concluded by the end of the year (but is likely to lead to measures much sooner). There is a direct precedent – in March 2002 the EU adopted safeguard measures in response to US steel tariffs. Safeguard duties conformed to WTO rules and only started to apply when imports exceeded traditional levels. Imports from China have increased sharply since 2002 (Chart 6) but the EU is likely to adopt measures to prevent Chinese steel intended for the US from flooding the market. Domestic demand is likely to remain firm, with the European Commission construction confidence indicator for the EU at long-term highs.

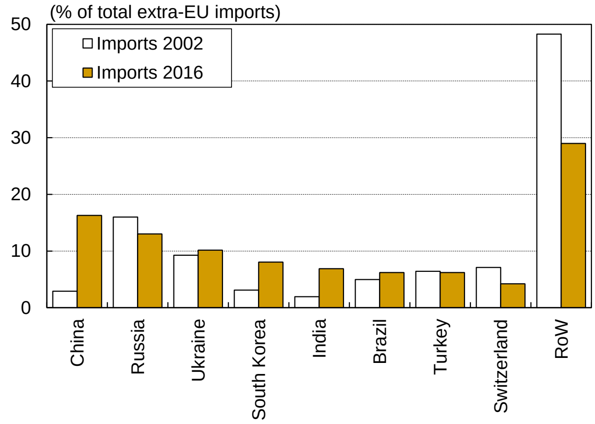
Overall we are confident that the relatively small trade flows and likelihood of safeguard measures mean that the announced measures in isolation will not be a significant drag on European GDP growth.

Chart 5: Top 20 Exporters of Iron and Steel to the US



Source: WTO, US Census Bureau, MUFG Bank Economic Research Office

Chart 6: Main EU Import Partners for Iron and Steel



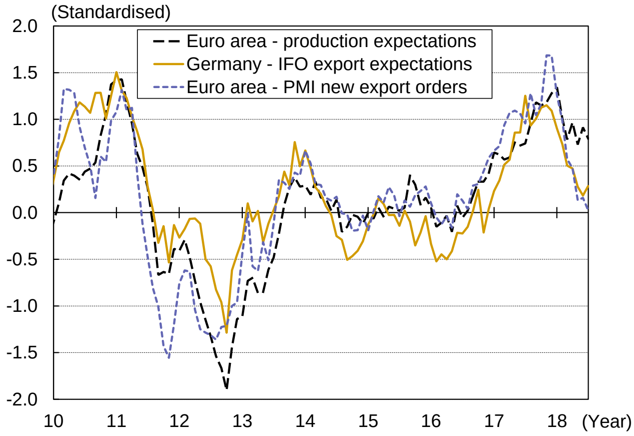
Source: Eurostat, MUFG Bank Economic Research Office

(2) Business confidence

The effect on business confidence is more important – not just in response to the already-announced tariffs, but to the perceived threat of further escalation. However, even prior to the current rise in protectionism, we may well have been reaching a cyclical peak in global trade. Imports have been growing above the pre-GFC pace and global financial conditions are tightening as the Fed continues its gradual hiking cycle. For this reason it is hard to disentangle what the effect of escalating protectionism is on business sentiment. Indeed, Chart 7 shows how euro area export orders and German export expectation indicators had already started to soften at the end of 2017 – before Trump announced the first tariffs. The European Commission's production expectations series has not weakened as much, suggesting that domestic demand remains relatively resilient. It seems likely that most but not all of weaker sentiment can be attributed to the protectionism threat.

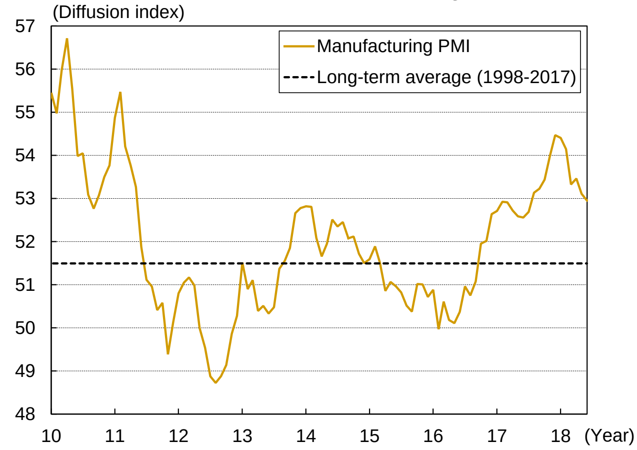
Nonetheless, we are cheered by the global manufacturing PMI (Chart 8), which, while a bit weaker, was still firm at 53.0 in June – well above the long-term average. In the euro zone, German factory orders and industrial production comfortably beat expectations in May which is also reassuring. To our minds it is most likely the threat of further tariffs has weighed on confidence rather than the announced measures themselves. However, this does mean that investment plans may be put on hold given the increased risk. Trump's actions can seem quite erratic, so even if his rhetoric on trade eases it may still take a while for businesses to regain confidence.

Chart 7: Business Sentiment Indicators



Source: IHS Markit, European Commission, Ifo, MUFG Bank Economic Research Office

Chart 8: Global Manufacturing PMI



Source: IHS Markit, MUFG Bank Economic Research Office

(3) Inflation

Lastly, one of the most immediate and noticeable effects of tariffs can be inflation. Tariffs on washing machines and solar panels were the first measures announced this year. We note that the laundry equipment component in US CPI has increased by 19.9% since March. In Europe, the EU has imposed tariffs on many consumer goods in retaliation to the US steel and aluminium duties which may put upward pressure on overall HICP. But many of the items, such as orange juice, are readily substitutable so the effect may be limited.

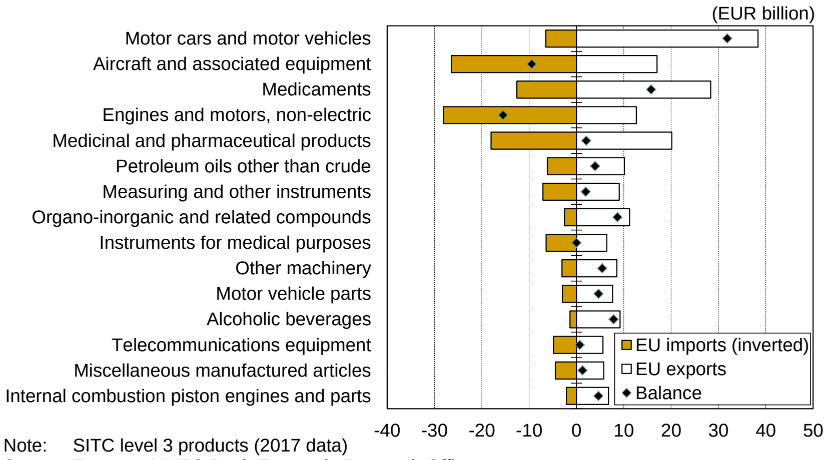
4. The risk of further escalation

As mentioned above, it is the perceived threat of further escalation that may affect investment decisions and confidence.

Average tariffs may be lower globally, as shown in Chart 2, but this hides some anomalies. Historical lobbying pressure and special interests have meant certain products are protected by very high tariffs either side of the Atlantic. For example, US import tariffs on raw tobacco is 350% and over 130% on peanuts – meaning any trade is effectively stopped. We also highlight differences on the same goods. There is a 14% duty on imports of train carriages to the US but just 1.7% on these when imported to the EU. These types of imbalances open up the potential for grudges, political point scoring and an escalation of tit-for-tat trade measures.

Which goods would be most vulnerable? Chart 9 shows which goods are traded most between the US and the EU (by SITC classification). While trade in aircraft, medicine and chemicals is significant, the most traded class is motor cars – and the EU has a clear surplus. On top of this, the EU tariff on cars from the US is 10% but in the US it is only 2.5% on imports from the EU.

Chart 9: The EU's Most Traded Goods with the US



Note: SITC level 3 products (2017 data)
Source: Eurostat, MUFG Bank Economic Research Office

Overall, the EU is the world's largest car exporter and the US is the largest importer. With this in mind it is not surprising that EU car exports may be targeted by the US. On 22 June Trump tweeted:

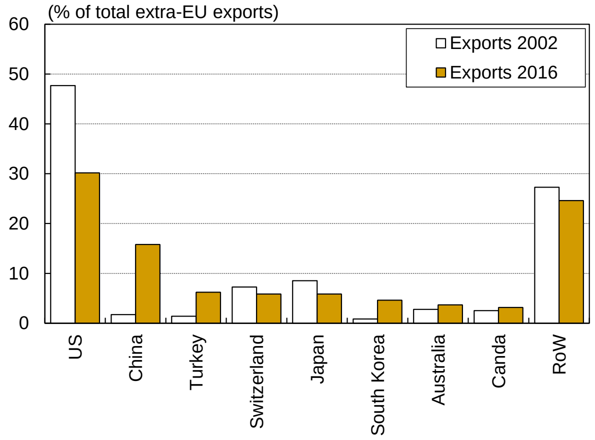
> "*Based on the Tariffs and Trade Barriers long placed on the U.S. and its great companies and workers by the European Union, if these Tariffs and Barriers are not soon broken down and removed, we will be placing a 20% Tariff on all of their cars coming into the U.S. Build them here!*"

20% tariffs on cars would be much more concerning than the already-announced measures on steel and aluminium. Because of the weight of motor vehicles and parts in overall trade, the average tariff imposed on EU imports by the US would roughly double according to BoE estimates (to 6.2%). We note, while still clearly ahead of other countries, the share of the US in EU exports of cars has declined sharply between 2002 and 2016 (Chart 10). The EU is less reliant on the US market. This probably reflects EU manufacturers moving some production to the US, though. Chart 11, which shows imports, suggests a similar shift for Japanese manufacturers to produce vehicles in Europe.

Overall, the effect may actually be fairly limited over the medium term. The CPB (the Netherlands Bureau for Economic Policy Analysis) considers a scenario of the current steel and aluminium tariffs, retaliation by key partners, further escalation between the US and China – and 25% US tariffs on motor vehicle imports from the EU. In this case, the CPB's computable general equilibrium model suggests that EU GDP may actually *increase* by 0.2% compared to the baseline in 2030.[1] It is explained in the report that the US-China trade war would divert trade to other partners, allowing the EU to regain losses from the tariffs on metals and cars.

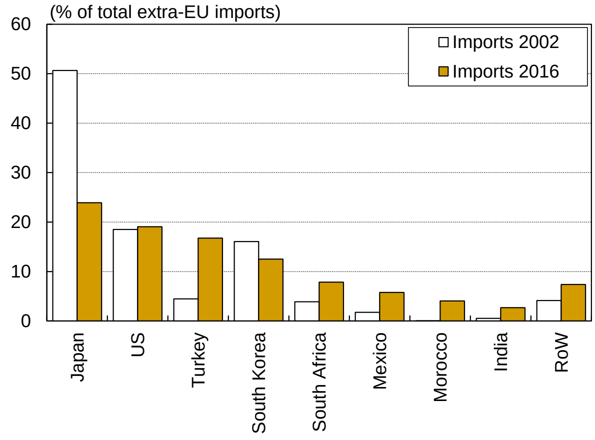
[1] See here: www.cpb.nl/sites/default/files/omnidownload/CPB-Background-Document-July2018-Trade-Wars-update.pdf

Chart 10: Main EU Export Partners for Cars



Source: Eurostat, MUFG Bank Economic Research Office

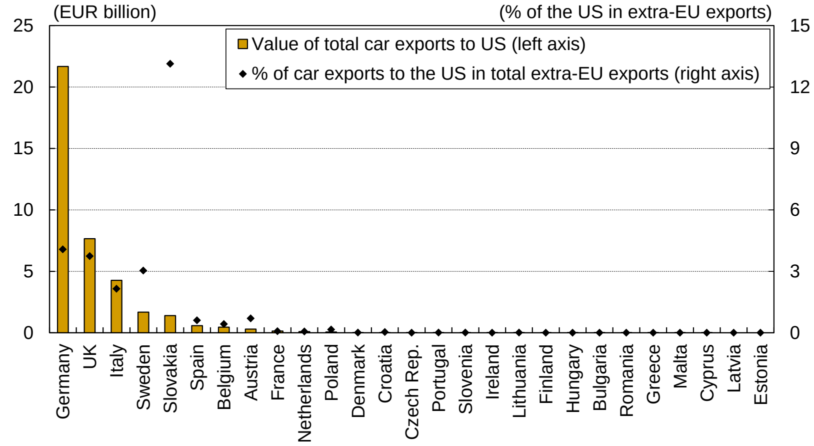
Chart 11: Main EU Import Partners for Cars



Source: Eurostat, MUFG Bank Economic Research Office

However, the effect of car tariffs would not be uniform between member states. Total EU exports of cars and car parts to the US were worth 0.3% of EU GDP in 2017, eight times more than steel and aluminium, but some individual countries are much more exposed than others. 49.8% of Italy's extra-EU exports of cars went to the US in 2017. Sweden (42.0%), the UK (34.8%) and Slovakia (32.9%) could also be affected. For Germany, the largest exporter, 29.9% of extra-EU German car exports went to the US. Chart 12, below, shows the total value of car exports to the US in 2017, and how much these account for in *total* extra-EU exports by member state.

Chart 12: Total Car Exports to the US by Member State



Source: Eurostat, MUFG Bank Economic Research Office

A rough calculation, taking the mooted 20% tariff and assuming price elasticity of demand on cars to be -1.2 suggests that car exports to the US could fall by 10 billion EUR. By member state, exports from Germany could fall by 0.16% of GDP, the UK and Sweden by 0.08% and Italy by 0.06%. In reality, carmakers may reduce production or increase capacity in the US, so these numbers should be taken with a pinch of salt.

Also, it is not just the export of finished cars that matters. Much of the supply chain, especially in low-to-mid value production, has shifted from western Europe to central and eastern

European (CEE) countries over the last decade as production processes are increasingly integrated across borders. In Hungary, for example, now over 5% of gross value added is accounted for by the automotive industry. Intra-EU exports of parts and accessories of motor vehicles were worth between 6.1% and 4.0% of GDP in the Czech Republic, Hungary and Slovakia in 2017. Poland, Slovenia and Romania are also exposed. This would mean that the imposition of US import tariffs on cars would also affect these CEE economies to an even greater extent than is suggested in Chart 12 above.

5. Assessing the threat

(1) Trump and Juncker have announced a ceasefire

Trump met with European Commission president Juncker on 25 July and the leaders struck a conciliatory tone. There was an agreement to “work together toward zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods” and the ambition to “launch a close dialogue on standards in order to ease trade, reduce bureaucratic obstacles, and slash costs”.

We note, though, that there was little of substance. While Trump also said that the EU would “start, almost immediately, to buy a lot of soybeans” and “import more liquefied natural gas” from the US, we are unclear how this could work in practice. Trade in both will continue to be driven by market forces. Dry weather in Europe could naturally increase demand for cattle feed while the 25% Chinese tariff on US soybeans is likely to mean that American exporters turn to Europe. Meanwhile, the tariffs on steel and aluminium will remain in place and, most importantly, any measures on cars were not mentioned in the statements.

(2) Risks remain

Overall, the meeting appears to have been constructive but the US president is unpredictable and a single tweet could cause the agreement to unravel. The threat of auto tariffs continues to loom in the background.

As explained above, the source of contention is the 10% EU import duty versus the 2.5% US equivalent. Tariffs on trade in cars with the US falls under the WTO most favoured nation concept which requires that third parties outside of trade agreements are treated equally. For the EU to reduce tariffs on US cars, it would ostensibly have to reduce tariffs for every other country with which it does not have a trade agreement. “There is no way I can see the member states agreeing to that” said EU Trade Commissioner recently – but perhaps there is another way. The EU is said to be considering a “plurilateral” trade deal, which would reduce tariffs for the US and some other countries, but not all, and would be acceptable under WTO rules. Angela Merkel, the German Chancellor, has indicated her support. Such a deal would be a relief for automakers, and could even improve upon the status quo. Currently there is a 25% US tariff on European pick-up trucks and vans, which makes exports to US unviable. The EU may seek concessions on this in order to reduce its 10% tariff on cars.

If this fails and tariffs are raised on EU car exports then the EU would almost certainly respond proportionally in what would be another step towards a global trade war. Overall, it is not easy to estimate the effects of this on the European economy. The first step is to define what tariffs would be in such a situation.

The ECB considers a scenario in which the US raises tariffs on all goods by 10 percentage points and its trading partners respond with equivalent measures. In this case, it estimates that world GDP could fall by up to 1% in the first year. Euro area activity would decline, “but by less than in the US” where real economic activity could be up to 2.5% of GDP below the baseline scenario in the first year. The ECB is perhaps reluctant to put a figure on the effect on European growth, but the BoE is more explicit. In an identical scenario of 10% tariffs between the US and its trading partners its simulations suggest that the peak impact over three years for the euro zone is a loss of just over 2% of GDP, taking into account the effect on business confidence and financial conditions as well. For the UK, with goods exports less important to the economy, it is around 1.5%. Looking further ahead, the effect could be persistent. The CPB estimates that 10% tariffs on all goods between the US and OECD countries and China would cause EU GDP to be 2% lower than their baseline by 2030.

These are worrying figures. It is important to note that the estimates assume 10% tariffs between the US and its trading partners – but not between everyone else. If all countries impose tariffs on each other there is the potential for an even larger fall in output. For now, this seems unlikely as most countries seem united in denouncing the US tariffs. But the imposition of safeguard measures, if not handled sensitively, could provoke tensions between the EU and China.

Mario Draghi, the ECB president, has said that “downside risks to the outlook [in the euro zone] mainly relate to the threat of increased protectionism”. It is not surprising that central banks are considering the effects of a trade war. The inflationary effect of tariffs combined with weaker confidence and lower output is an extra complication at a time when policymakers are wrestling with the normalisation process. Looking beyond the immediate effects, globalisation is often put forward as an explanation for the secular trend of lower inflation as integrated supply and production chains, and a more global labour market, may well have pushed down prices. Higher tariffs may well mean that the Phillips curve could shift upwards and become steeper.

6. Conclusion

Any increase in barriers to trade is net negative for the world economy. However, the direct effect of the already-imposed measures on steel and aluminium is likely to be limited for the EU which has relatively low exposure compared to other economies and probable safeguard measures would protect from trade diversion. And if other economies do not implement similar measures the EU may actually benefit from trade diversion effects as several countries retaliate against the US at the same time.

Indirect channels are likely to be more significant with uncertainty and weaker confidence weighing on investment. With this in mind, the European Commission has recently revised down its estimate for 2018 euro area GDP growth from 2.3% to 2.1% YoY. This is “predicated on the non-escalation of trade tensions and conflicts at a global level”.

There are significant downside risks. Donald Trump has EU car exports in his sights which are much more important to the European economy, although tariffs on vehicles would affect some countries more than others. The economies of key exporters of finished cars (e.g. Germany, UK, Italy) and smaller countries which are highly involved in the production process (e.g. Hungary, Slovakia, Czech Republic) would be particularly exposed. Moreover, higher tariffs would provoke immediate retaliation from the EU and could set off a series of tit-for-tat measures resulting in rapidly increasing average tariff rates. With the clash between China and the US already more advanced, there is a clear risk of financial market contagion as nerves are raised about global growth prospects.

However, the recent meeting between Trump and Juncker appeared constructive, even if little of substance was agreed, and there is a chance that the EU will manage to negotiate a plurilateral agreement to reduce car tariffs on US imports. This could ease tensions but it is impossible to predict how the situation will evolve given Trump's erratic approach to foreign policy. There is also a possibility that his energy for trade disputes may fade after the US mid-term elections in November. In this case we think there could still be a persistent drag on business sentiment as firms may not believe the threat of further tariffs has disappeared entirely.

Lastly, we note that the timing of this increase in protectionism is particularly bad for the UK as it leaves the world's largest trade bloc and seeks deals with third parties.

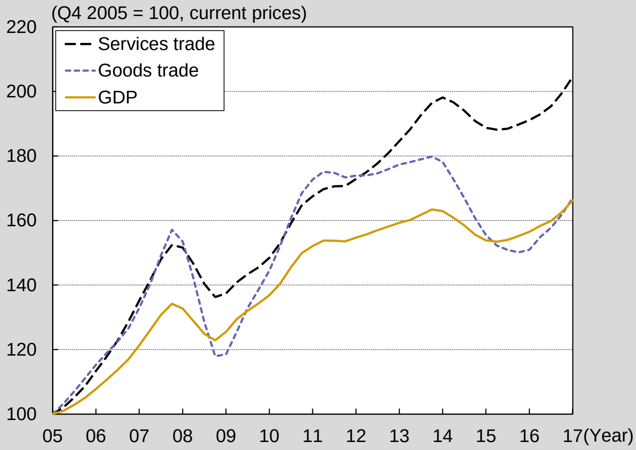
Box 1: Services trade increasingly important

Tariffs are applied to goods trade – but what about services trade, which is not subject to tariff barriers? We note that global trade in services is increasingly important, driven by advances in digital technology. Chart A shows how growth in services trade has outpaced that in goods trade since 2005. This shift to services means that European employment may be more resilient to reduced goods trade flows. Chart B shows how employment in manufacturing has been declining in developed economies since 1960 as processes are increasingly automated.

Meanwhile, services trade is notoriously hard to measure so there is a large disparity between the Eurostat estimate of the balance (provisional data shows a 23 billion EUR *surplus* for the EU in 2017) and the US BEA estimate (which shows the EU had a 46 billion EUR *deficit*). On account of the latter the US may not seek to impose barriers to trade in services, even if tensions escalate further. In fact, literature suggests that services trade is not especially responsive to decreases in trade barriers, so it seems plausible that the opposite also holds. [2]

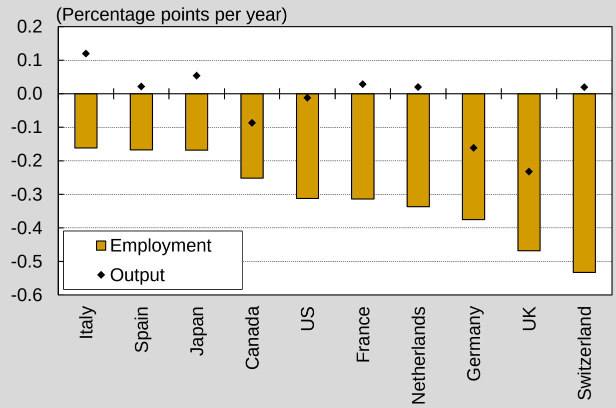
[2] See e.g. Assessing the Impact of Trade Agreements on Trade (Ebell, 2016).

Chart A: Global Goods and Services Trade



Source: World Bank, WTO, MUFG Bank Economic Research Office

Chart B: Annual Average Growth Rate in Manufacturing Employment and in Value Added Shares (1960-2015)



Source: IMF, MUFG Bank Economic Research Office