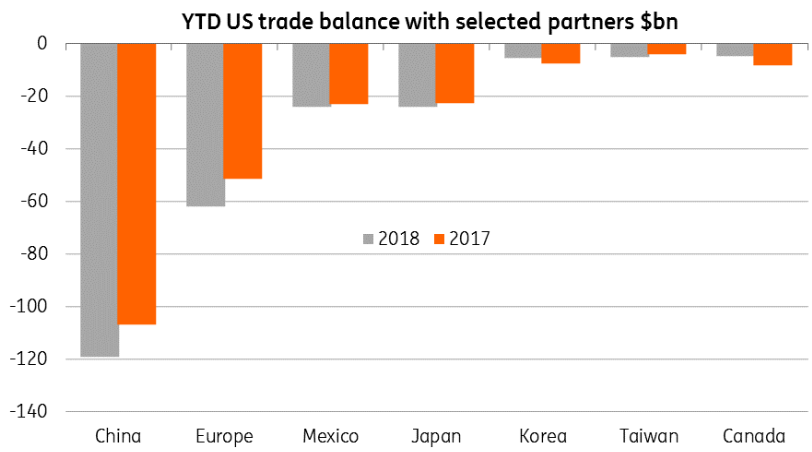
A trade war between the EU and US, a lose-lose situation

Trade wars are good and easy to win, according to US President Trump, but higher tariffs lead to few winners and many losers. If the current 'tit for tat' rhetoric between the US and EU really results in a trade war, neither will walk away scot-free



Tensions between the EU and US have been rising since President Trump announced higher import tariffs on steel and aluminium last Thursday. EU trade commissioner Cecilia Malmström has said that the EU would have to respond and put in place reciprocal tariffs.

The EU has prepared a list of products, if indeed the US were to implement duties, including a 25% tax on a number of steel products, agricultural products and consumer goods. In turn, President Trump said that the US would retaliate by imposing tariffs on European auto sales.

The domino effect

Assuming the worst, a situation like this could lead to a domino effect resulting in tariffs on the lion's share of all product groups. If we assume that this results in an average tax of 10% on EU exports to the US and the EU levying an additional 10% tax on imports from the US, this will have a negative economic impact on the US economy of -0.4% after two years while the EU will see damage to GDP amounting to -0.3%.

Everyone loses

Both the EU and the US will see the volume of their bilateral exports decline due to the import taxes. As a percentage of total exports, this loss will be somewhat lower for the EU because companies that export to the US tend to compensate 70% of cost increases (like tariffs) by lowering their profit margins, while US companies do this only for 40%. Lower profit margins add to the losses incurred by businesses, on top of weaker demand from abroad.

The negative effects on exports are limited, but for both sides, the substitution of imported goods by domestic production is even smaller because both the EU and the US will partly substitute the imports from each other by imports from other countries (we assume that this will be the case for half of the products).

So the overall macroeconomic impact of mutually increased import taxes would be negative, even though limited parts of the economy could stand to gain. While that might be the purpose of the measures, to begin with, the consequences are negative for the overall economy.

This is especially the case for the US as its tariffs are not limited to the EU but global, risking a broader trade war.

Second round effects

While the impact of the tariffs on GDP through trade may be small, second round effects of tariffs could have significant consequences. Lower profit margins for exporters could impact domestic investments for example. Higher inflation and economic uncertainty would leave central banks in a difficult situation regarding the setting of interest rates. The risk of a broader move towards protectionism has significant economic consequences alone.

As the impact of a trade war reaches well beyond trade volumes, the losers far outnumber the winners.

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