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Trump car tariff won't derail EU economy but escalation of trade war could

President Trump has threatened to step up his trade war with the EU by raising import tariffs on European cars by 20 percentage points. By itself, this wouldn't derail the European economy but second-round effects could lead to serious economic damage

Source: Shutterstock

No deal in sight

It is not a sure thing yet but President Trump has said that the investigation into car imports from Europe (and possibly other trade partners of the US) is almost finished and action could be undertaken soon. During a visit to Washington tomorrow, Jean Claude Juncker will try to change

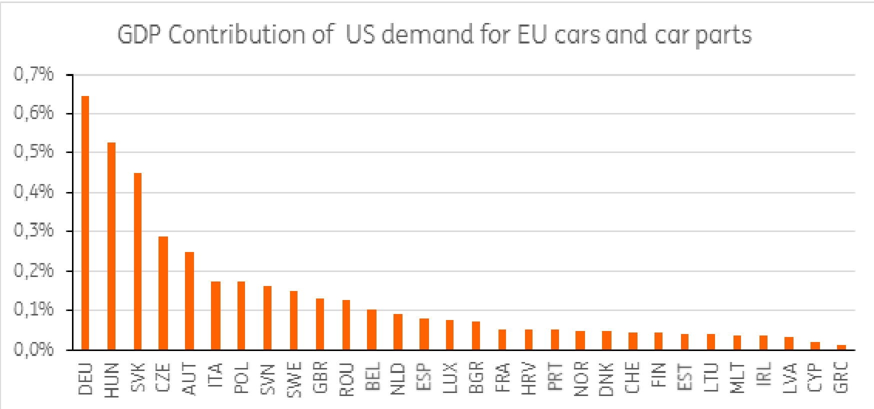
Trump's mind. The odds are that he won't succeed. Instead of presenting a concrete proposal to ward off a war on cars, the president of the European Commission is hoping to convince Trump that a trade war leads to losses on both sides of the ocean.

Limited effect

If the US were to impose a higher tariff of 22.5% (up from 2.5% currently) on imported European cars and car parts (and possibly cars and parts from other countries), the direct effect on the European economy would be limited to 0.1% of EU GDP. This is due to the fact that the value added of exports of cars and car parts to the US makes up only a small part of EU GDP (0.22%). But if the conflict between the world's largest importers has a medium- to long-term negative effect on the confidence of businesses, consumers and investors, it could lead to more serious damage, especially if the trade war escalates further.

Fig. 1: Limited exposure of European automotive to US demand

Source: WIODD database 2017, calculations Universiteit van Groningen



Germany gets hurt most, followed by Hungary and Slovakia

Germany is most exposed to US demand for European cars because its share of total exports of cars and car parts that goes to the US is the highest of all EU countries (see figure). But at the same time, the figure shows that even for Germany's flagship auto industry, a rise in American import tariffs is not the disaster many think it is. While the industry is the export champion of Germany and serves as a source of national pride, higher US import tariffs on European cars and parts are not enough to cause a recession. The automotive sector may be the biggest industry in Germany and the frontrunner of German exports but it still makes up no more than roughly 5% of German GDP. Despite having a strong industrial base, Germany's economy is largely (71%) made up of services.

On top of this, less than 9% of the value added of German car exports is generated by demand from the US for European cars. This only represents 0.34% of German GDP. This is lower than traditional export figures indicate, but the traditional export figures treat imported commodities and foreign intermediate products in cars that Germany exports to the US as if they were produced in Germany. German automotive companies also supply car parts to car makers located elsewhere in the EU. If we take that into account, the share of the German economy linked to American demand for European cars rises to 0.65% of GDP. This is not negligible but neither shocking.

Next we have to realise that a tariff hike of 20 percentage points will reduce American demand for German cars somewhat but not wipe it out completely. So the effect on the production and earnings of German automotive companies will be limited. Also, the lion's share of German car exports is made up of higher-end vehicles like Porsches and Audis, and price hikes on these cars tend to have little impact on demand. The price elasticity of lower-end, more common cars, is generally higher so producers of those cars, like Volkswagen, Peugeot, Renault and Fiat, will probably face a larger reduction in demand. But for the French and Italians, the effect on the overall economy will be even more limited because they have relatively little exposure to the American market (see Figure).

What holds for Germany, also holds for Hungary, Slovakia and the Czech Republic. These countries are also strongly associated with the automobile sector. Therefore, it's no surprise that they are next in line when it comes to exposure to the US. But the direct effect on the overall economy, through lost revenue in the automobile sector, is rather limited as well.

Second-round effects can make things worse

Of course, the initial effect on the economy has second-round effects. Less income is normally followed by less spending (multiplier effect). So a fall in US demand for European cars will suppress European economic growth more than the initial effect. But even if we take this into account, our estimate of the export damage for the EU is no more than 0.1% of GDP. The equivalent for Germany would be a hit of -0.25%. But the damage could well be lower because, as said, demand for high-end German cars could be relatively insensitive to price.

The economic damage could be even lower if the EU retaliates. Higher import prices for US products will increase demand for local substitutes, which will reduce the negative effect of lower exports by almost half. It should be said however that a ‘tit for tat’ trade battle over cars comes at the expense of consumers on both sides of the ocean. They will have to pay up for their cars, be it imported cars or local substitutes.

The experience in the current trade war between the US and China indicates though that the mitigating effect of retaliation on production levels could be very short-lived because retaliation could well lead to further protectionist steps by the US government. President Trump sees the imposition of tariffs as necessary to restore a level playing field in trade between the US and its trade partners. In his view, retaliation simply makes trade unfair again and therefore warrants additional tariffs. This ‘tit for tat’ policy has led to an escalation of the trade war between the US and China.

Trump plays hard ball

For those who think that President Trump will treat the EU with leniency because of long-standing political and economic ties, it's wise to remember that he showed little sympathy when applying steel and aluminium tariffs to the EU and even to Canada and Mexico. Moreover, Trump has said that the EU is "as bad as China" when it comes to trading fairly with the US.

Although the G20 meeting last weekend in Buenos Aires suggested that the US is open to negotiating a deal on trade with the EU, it will probably be on Trump's terms, as seen by the experience of recent negotiations with China. It seems unlikely that the US will give in to demands from the EU that the US takes back additional tariffs on steel and aluminium before negotiations can start.

The EU commission has already indicated that it could well decide to retaliate if Trump imposes higher tariffs on cars. So this could easily lead to an escalation of the tariff war.

If a large share of trade between the US and EU becomes subject to higher tariffs, the economic damage would be much more significant on both sides of the ocean. A mutually imposed tariff of 20% on all goods would cost the EU 0.6% of GDP and the US 0.8%. Confidence indicators will probably go down when negative economic effects of this size occur. If confidence levels among businesses, consumers and investors fall for an extended period of time, the direct negative effects of the trade war would be amplified and bring the EU economy closer to recession territory.