17 May 2018

Research Briefing | Eurozone

US tariffs pose minor economic but major political risk

Economists

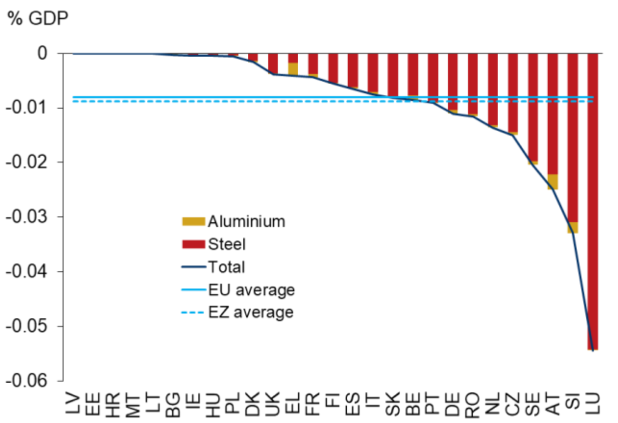
Oliver Rakau
Chief German Economist
+49(0)69 9675 8664

Taha Saei
European Economist
+44(0)20 3910 8044

- **The trade talks between the US and the EU have turned into a stand-off with both sides now digging their heels in ahead of the June 1 deadline. Should the US decide to impose tariffs on European steel and aluminium, the direct economic impact should be easily manageable given the modest size of the affected trade flows. However, the spectre of an escalation is likely to weigh on business sentiment and may derail the investment recovery.**
- The EU secured a last-minute temporary exemption from US tariffs in April, and while there has been plenty of posturing there seems to have been little progress in negotiating a permanent solution. With the clock ticking, it now looks quite likely that EU exports to the US will soon face tariffs of 25% on steel and 10% on aluminium.
- Our calculations show that for EU countries the economic hit would be well below 0.1% of GDP. This shouldn't be surprising as the affected exports (worth about €7bn in 2017) account for only around 0.1% of all EU exports. Even the most exposed countries would only see about 0.2-0.3% of their total exports affected by tariffs.
- Moreover, any adverse impact on European firms' order books is softened by a lack of adequate domestic supply from US metal producers, at least in the short-run. In addition, US metal producers have hiked prices materially, meaning tariffs will not have fully eroded EU steel and aluminium price competitiveness. However, that has not prevented sentiment in the metal sector from nosediving as the impact on profits may be concentrated on a few firms.
- However, the real threat to the EU comes from its lack of a strategic answer to the "America first" policy. Europe still looks for a win-win situation, while the US employs its more assertive foreign policy approach to address several gripes it has with the EU, such as the level of defence spending or the large bilateral trade surplus. That creates a level of uncertainty that could become a headwind for investment.

Direct demand hit from tariffs below 0.1% of GDP for all EU countries

EU: Negative demand impact from US tariffs



Source: Oxford Economics/Haver Analytics/White House/WTO/US Census Bureau

Our calculations suggest that the US imposing a 25% tariff on steel and of 10% on aluminium imports from the EU would have an overall negligible effect on the EU economy. US imports from Germany may be hit the hardest falling by just below €0.5bn. In relative terms, that would only be slightly above the EU average of 0.01% of GDP. On that measure, Luxemburg, Slovenia, Austria and Sweden stand out, but no country looks in for a hit of more than 0.1% of GDP.

Contact: Oliver Rakau | orakau@oxfordeconomics.com

Economic impact minor – political fallout major

Imposition of tariffs has become increasingly likely

The clock is ticking. Absent a last-minute deal, the temporary exemption of European exports from US tariffs on steel and aluminium imports could end as soon a June 1. That could mark a turning point in the bilateral trade relationship between these two economic power houses.

Despite the urgency and a sharper rhetoric in the last few days there is little to suggest that backroom talks are yielding significant progress. While we continue to view a full-blown trade war as a remote risk, it has become increasingly likely that the US will soon slap the EU with some form of tariffs or quotas. In this *Research Briefing*, we will assess the potential economic effects and explore possible political implications.

Manageable direct economic impact…

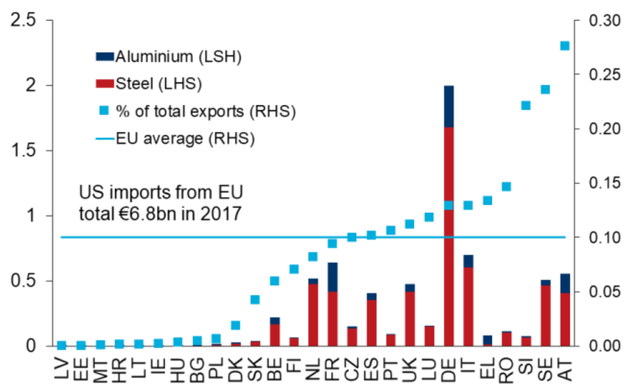
The macroeconomic impact of the proposed US tariffs of 25% on certain steel imports and 10% on certain aluminium imports on the EU looks easily manageable, even if that would present a sizeable jump from the prevailing rates of between 1% and under 4%. We have highlighted for a while that the metal tariffs by themselves hold little threat for the global economy (see our global and regional coverage, Asia, US). In our calculation, the direct hit to demand from more expensive European steel and metal amounts to under 0.1% of GDP for all EU countries with an average impact of a tiny 0.01%. However, a bigger concern is the damage a potential diplomatic fallout will do to US/EU relations. The dispute may well end up in front of the World Trade Organisation, leading to a protracted arbitration process.

The key reason for the limited impact is size (chart 1). Steel and aluminium are simply not key EU exports. The affected EU shipments were less than €7bn in 2017 (eurozone: €5.5bn), which is about a tenth of a percent of all EU exports. In absolute terms, German exporters would be hit the hardest as they account for around a third of all exports. In relative terms, Austria, Sweden and Slovenia stand out as between 0.2-0.3% of their total exports would be hit, well above the 0.1% EU average. In stark contrast, the EU is an important source of the affected metals for US manufactures accounting for 18% of their imports.

Chart 1

EU: Tariff-affected US metal imports by country

2017; bn EUR (LHS); % of country's total exports (RHS)



Source: Oxford Economics/Haver Analytics/US Census Bureau

The United States imported a total of below €7bn of steel and aluminium from the EU in 2017, which could be hit by US tariffs. German exporters stand to lose the most as they export about €2bn worth, but in relative terms Austria, Sweden and Slovenia stand out, as their US exports account for between 0.2-0.3% of their total exports. That is well above the 0.1% EU average. Luxembourg is an outlier because of its small size.

The other key reason why direct risks to European manufacturers are limited is the industrial set up in the US. Steel and aluminium producers in the world's largest economy will certainly aim to fill gaps left by fewer European imports. However, the US is a net importer, so metal-using manufacturers will at least initially struggle to find enough domestic sources. In addition, history has shown that there are strong incentives for US

Contact: Oliver Rakau | orakau@oxfordeconomics.com

metal producers to materially hike prices, partially offsetting the tariff-induced loss of competitiveness for EU firms. Hence, based on demand changes to previous tariff changes our calculations suggest that exports would be reduced by on average around 20%.

Tariff scenario equals a quota of 80% of 2017 imports

Our assessment would not change much if the US administration were to ask for a hard quota on EU imports instead of the tariffs. When the US extended the EU's and other key partners' exemption from the tariffs, it had suggested that it may prefer hard limits instead of letting market forces decide. Our tariff scenario holds similar macro implications as a quota of 80% of the 2017 trade flows, though, it would be politically more contentious.

...but some firms could be hard-hit given dependence on economy of scale...

While there are several additional transmission channels that may modestly increase the impact of the tariff shock on the wider economy, we believe they will primarily hit European metal manufacturers' bottom line.

First, US exports account for a sizeable portion of the European basic metal sector's business. Across the EU, they account for around 2% of the sector's turnover, but for more exposed countries that number is closer to 4% and as high as 7% (Netherlands). Therefore, tariffs may turn into a real threat for some firms for which the US business is a major source of revenue. That risk has already damped business confidence judging by the latest readings of Germany's Ifo Institute's sentiment indicator and may weigh on investment intentions.

Second, the prospects of slowing business flows from the US will strengthen metal producer customers' bargaining position in upcoming renegotiations of supply-contracts. That likely hit to the bottom-line is also reflected in the latest ZEW survey, where profit expectations for the metal and automobile sector were the only ones in clearly negative territory.

Chart 2

Price expectations in German metal production have tumbled since January, when the threat from US sanctions became more and more apparent. The last time we saw such a decline was in late-2008. Firms' expectation of their price setting power will likely have been dragged down by fears of lower exports to the US and potentially rising competition from redirected Chinese production.

...and re-directed excess production from China could weigh on prices

Third, concerns over firms' pricing power are additionally fuelled by fear that excess Asian production may flood the European market. While China accounted for only 8% of US imports in 2017, less than half of the EU imports, there would be a measurable impact on European producer prices. However, we doubt that this deflationary effect will reach European consumers. More likely, the windfall from lower input costs will be split along the supply chain as suggested by the high level of the overall manufacturing price expectations.

Contact: Oliver Rakau | orakau@oxfordeconomics.com

OXFORD ECONOMICS

Political and diplomatic complexities are daunting

Quota or tariffs? Or a broader deal?

While there has been a flurry of communication coming out of Brussels and Washington in recent days, there's little white smoke. Last night, EU leaders continued to demand a permanent exemption. In exchange, technocrats in Brussels have come up with a list of largely minor proposals that appear to result in a win-win. These include reducing reciprocal tariffs on cars, for now undefined closer cooperation in ``the area of liquefied natural gas'' and lower product safety standards.

That appears to be a U-turn from last week when we had tentative signs that the EU is beginning to back-down from its hard stance. Reports said that the EU is considering a self-imposed quota on its exports of steel and aluminium to the US – capping these at the 2017 level. South Korea was the first country to negotiate such a deal.

We have doubts as to whether either deal would receive the full backing of EU leaders and the US. For one, the US had already offered such a self-imposed quota to the EU, setting them at 90% of the 2017 level, which the EU emphatically rejected. It is also questionable whether President Trump would view a modest quota or a broad set of minor adjustment as a significant economic concession by the EU to justify a permanent waiver – it's critical for him to appear to keep the upper hand ahead of the US mid-term elections later this year.

So, the situation remains highly fluid, with the added complexity that these negotiations happen against the backdrop of the highly contentious Iran sanctions. If they don't reach a resolution before the June 1st deadline, the EU has threatened to retaliate with its own protectionist measures, targeting €2.8 billion worth of imports from the US with tariffs of 20%, which reportedly can take effect as early as the 20 June. Still, delays are well possible given the political and legal constraints.

Plenty of uncertainty ahead for policy makers and affected firms

However, even this course of action remains highly uncertain. If the WTO were to find sufficient legal basis to assert that the protectionist measures imposed by the US are justified under national security grounds, the EU would have no legal grounds for retaliation. In any case, WTO proceedings are slow. After US president Bush imposed metal tariffs in 2002, it took one and a half years for a ruling and for the US to lift the tariffs.

This backdrop alone would make for a complex political challenge. However, while European policy makers may want to solve this issue in isolation, the US administration sees this as part of a wider set of differences. It may well aim to leverage this into concession about a lack of military spending and a large bilateral trade surplus. Both gripes are primarily with Germany and as we have shown, there is little appetite for a significant fiscal easing, which would be one way alleviate the United States' concerns.

We cannot help but question how successful the Europeans will be in playing the weak hand they have been dealt. This is not to say that we expect an escalation of the current trade dispute into a full-blown trade war. Equally, it appears very unlikely that the current level of uncertainty will be swiftly dealt with by decisive policy steps. Such simmering uncertainty with large scale downside risks is poison to firms' business outlook. This could well undermine the encouraging investment recovery we have seen over recent quarters despite the high levels of capacity utilisation and large backlogs.

Contact: Oliver Rakau | orakau@oxfordeconomics.com