Bond Blog

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Five Risks U.S. Tariffs Pose to EU Competitiveness

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In an increasingly fragmented world where greater competition is contributing to economic realignment and the U.S. election is fast approaching, the European Union remains vulnerable to renewed global trade tensions. Since 2018, when the region was subjected to U.S. steel and aluminum tariffs and threatened with potentially crippling auto tariffs, the EU's trade surplus with the U.S. has grown significantly. Ex-energy, the U.S. trade deficit with the EU now surpasses that of China (Fig 1), and this growing imbalance could well trigger a resurgence in U.S.-EU trade tensions. Despite being better prepared than it was in 2018, and against the backdrop of recent proposals to stem Europe's competitive decline,[1] we see five reasons why renewed trade tensions could be particularly economically damaging for the EU at this fragile time.

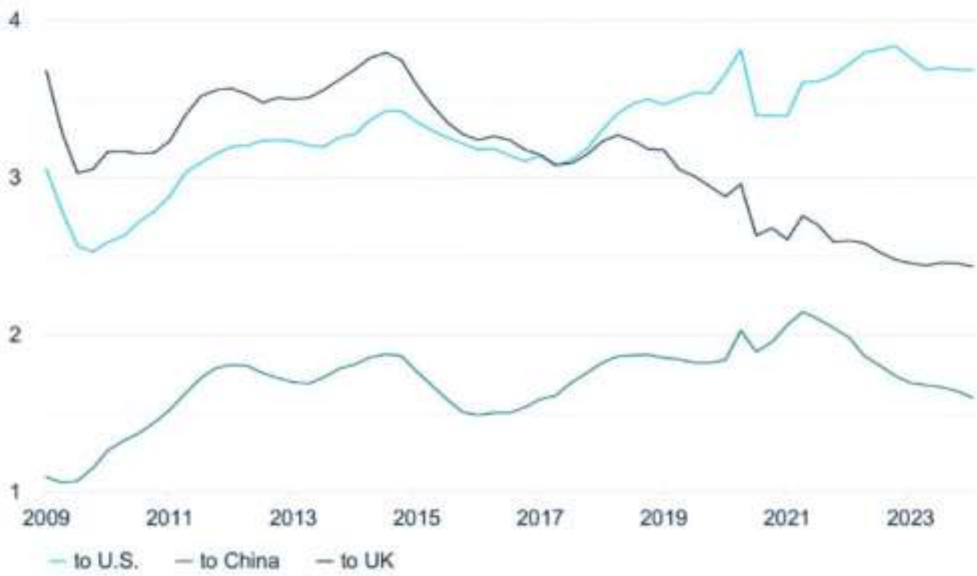
FIGURE 1: U.S. Trade Balance (USD Billions)

Source: Macrobond as of September 2024.

1. Size and Importance of U.S. Export Market

Despite rapid growth in the Chinese economy, the U.S. remains the world's largest global economy and the EU's most important export market (Fig 2). Given the size of the U.S. economy, any increase in imposed tariffs would likely result in a reduction in the price received by an EU exporter and, hence, an improvement in U.S. terms of trade at the expense of the EU. Moreover, the EU is a much more open economic region than either the U.S. or China, with a total (extra-EU) trade share of close to 45% of GDP, compared to around 35% and 25% for China and the U.S., respectively. Given the importance of trade to the EU economy, the impact of higher tariffs imposed by its largest trading partner would be severe.

FIGURE 2: Share of EU Exports to Top Three Markets (Share of GDP)

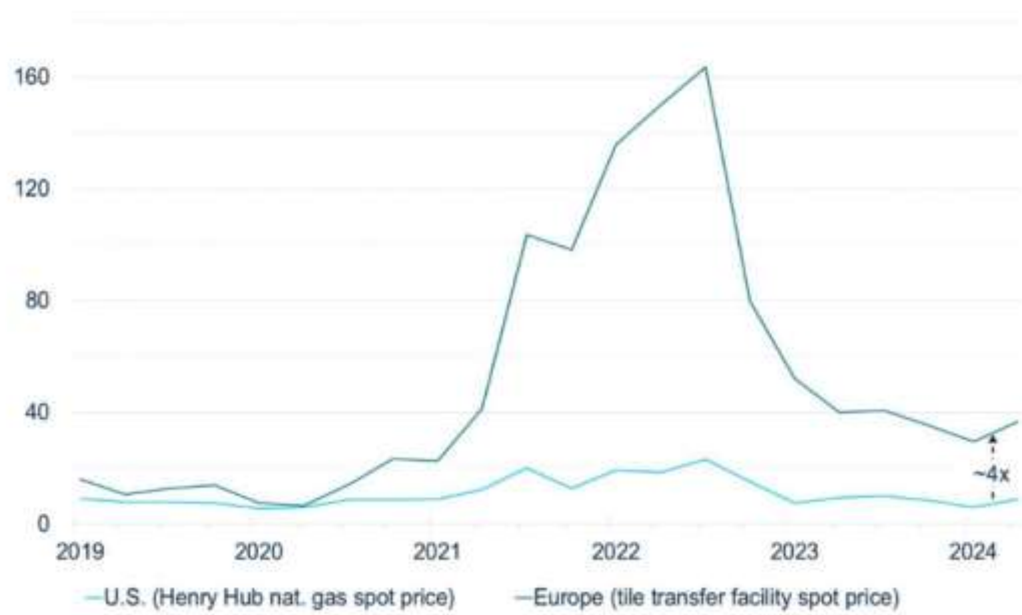


Source: Macrobond as of September 2024.

2. Tariffs Raise Cost of Exports

Since 2017, EU productivity has continued to decline relative to the U.S. In large part, the more recent deterioration reflects the substantial increase in energy costs borne by European producers following Russia's invasion of Ukraine (Fig 3). Higher tariffs effectively act as an increase in transport costs and would exacerbate the erosion in European competitiveness vis-à-vis the U.S. and China.

FIGURE 3: Wholesale Natural Gas Prices in U.S. and EU (USD per MWh)



Source: Macrobond as of September 2024.

3. Accelerated FDI Outflows

The combination of higher tariffs and production subsidies, such as the U.S. Inflation Reduction Act (IRA), could accelerate the outflow of European investment and production to the U.S. Since the U.S. has adopted an industrial strategy, we have already seen a further decline in net foreign direct investment (FDI) flows from the U.S. to the EU (Fig 4). The combination of tariffs and subsidies would provide strong incentives for European firms to relocate to the U.S., as these firms would stand to benefit from the subsidy while also avoid increased tariffs. Such a dynamic would likely further reduce private investment in the EU from an already low base. This, in turn, would have negative consequences for EU productivity and potential growth.

FIGURE 4: Net U.S. FDI Flows into the EU (USD Billions)

Source: Macrobond as of September 2024.

4. Asymmetric Tariffs Could Exacerbate China Excess Capacity

The potential for asymmetric tariffs levied on Chinese exports could exacerbate excess capacity issues there, putting downward pressure on Chinese manufacturing prices and incentivize dumping of Chinese products on European markets. This would further erode European competitiveness in its domestic market, as well as having deflationary implications (Fig 5). These could prove difficult for monetary policy to address in the absence of extraordinary measures. A lack of policy support, in turn, would likely result in a return to sluggish growth in the region.

FIGURE 5: Chinese PPI and Non-Energy Extra-EU Import Prices (% YoY)

Source: Macrobond as of September 2024.

5. Tariff Uncertainty

Even in the absence of higher tariffs, uncertainty alone could weigh on sentiment and, in turn, domestic demand as households and firms take a “wait and see” approach. This dynamic played out during previous bouts of uncertainty (Fig 6). Moreover, sentiment in Europe could be further rattled by more confrontational U.S.-EU relations given that the region has become much more reliant on the U.S. for energy imports. In particular, EU LNG and crude oil imports from the U.S. have risen from essentially zero in 2016 to 30% and 15%, respectively.

FIGURE 6: Trade Uncertainty Index and Business Sentiment

Source: Macrobond as of September 2024.

5. Conclusion

With the EU already facing economic headwinds and calls for more investment in order to boost growth growing louder, the prospect of renewed trade tensions with the U.S. comes at a particularly difficult time. For an economy still disadvantaged by high energy costs, even the prosect of higher tariffs has the potential to weigh on an already fragile economy. Whether higher tariffs do, in fact, come to bear remains to be seen, and the outcome of the U.S. election and its resultant trade policy is still highly uncertain. However, given the region's growing trade surplus with the U.S. and its resultant susceptibility to tariffs, the likely impact would be a further erosion of European competitiveness and be a headwind to growth.

1 European Commission: "The Future of European Competitiveness: Report by Mario Draghi," September 9, 2024.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, September 26, 2024

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