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Rising EU-US trade tensions only add to Europe's challenges

The EU is the latest region to be accused of unfair trade practices by the Trump administration. It is estimated that the EU has a trade surplus with the United States of $153 billion, which drops to $101 billion when services are included. Overall, trade between the two sides is worth more than $1 trillion annually, making it the world's largest bilateral trade relationship.[1]

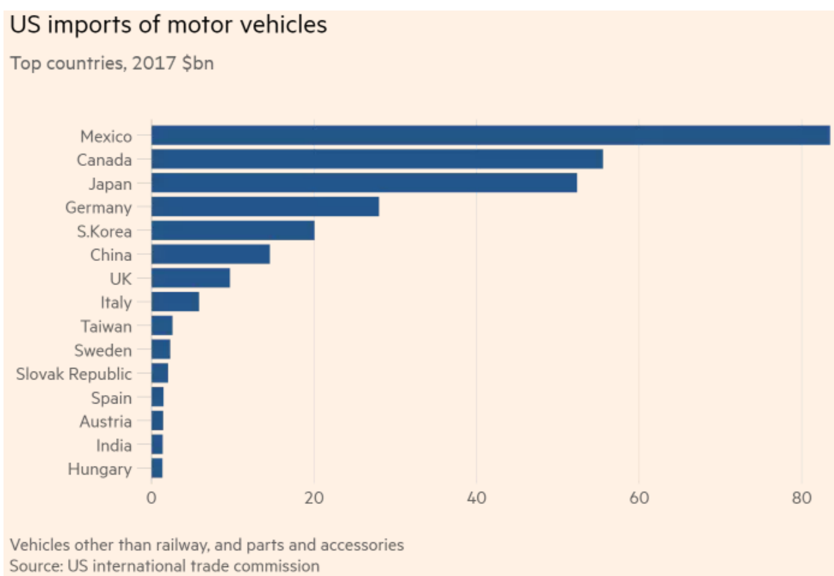
Unfortunately, this issue is being raised at a time when the EU is struggling with many other challenges, including deep internal divisions over migration and fiscal policy.

The vicious circle of tariffs and counter-tariffs

The United States has imposed duties of 25% and 10%, respectively, on steel and aluminum imports from Europe since the start of June. The EU has retaliated with over $3 billion in duties on various U.S. imports ranging from whiskey to motorcycles.

President Donald Trump, in turn, has threatened to impose a 20% tariff on all car imports from the EU. The United States imported $62.5 billion in motor vehicles and parts from the EU in 2017.[2] President Trump has long alleged that the EU engages in unfair trade practices when it came to the auto sector. The United States currently imposes a 2.5% tariff on cars imported from the EU and a 25% tariff on its pickup trucks. (The latter tariff was put in place in the 1960s due to a dispute with Europe over its treatment of U.S. poultry.) The EU imposes a 10% tariff on U.S. car imports. If Trump carries through on his threat, the EU would likely to respond with yet another round of counter-tariffs.

"We are finishing our study of Tariffs on cars from the E.U. in that they have long taken advantage of the U.S. in the form of Trade Barriers and Tariffs. In the end it will all even out - and it won't take very long!" (President Trump on Twitter, June 26)



"Trump car tariff threat prompts global condemnation," Financial Times, May 24, 2018

The United States is much less exposed to the fallout of trade tensions, its exports accounting for just 12% of GDP. By comparison, exports account for 44% of GDP for the EU.[3]

[1] The U.S. Office of the U.S. Trade Representative
[2] "Trump threatens Europe with 20 percent tariffs on auto imports," Washington Post, June 22, 2018
[3] The World Bank

Germany's trade exposure

Germany is one of the countries most vulnerable to a spike in trade tensions. It has the world's largest current account surplus (8% of GDP), which includes a trade surplus with the United States of $66 billion.[4] Exports account for 46% of its GDP.

Higher U.S. tariffs on car imports would hit Germany particularly hard given that the country's automakers exported nearly 500,000 vehicles to the United States last year.[5] In an effort to stave off these tariffs, Germany has pointed out that its automakers produced over 800,000 cars in the United States last year and employ over 100,000 Americans.

This threat coincides with worries that a hard Brexit could impede Germany's access to its second-largest export market. Germany has a 47-billion-euro trade surplus with the UK, which happens to be the destination for one in every seven cars it produces.[6] Finally, as if all this wasn't enough, Germany must contend with the long-standing threat of China's plan to challenge German dominance in advanced manufacturing in areas including robotics and machine tools.

Germany and France do not see eye to eye when it comes to the United States

Not surprisingly, because of its significant trade surplus with the United States, Germany is much more inclined to negotiate a compromise with the Trump administration than many other EU members. In a bid to avert trade disruptions, the German auto industry has called for the abolition of all tariffs on cars traded between the two regions. France, which is much less exposed to the United States than Germany is, opposes this proposal. Complicating matters even further, modifying EU tariffs requires the approval of all 28 members.

The risk of collateral damage from China-U.S. trade tensions

Even if Europe and the United States do avoid a major trade quarrel, the global supply chains that their companies rely on for components could be hit by trade tensions between China and the United States. For example, China's proposed 25% surtax on U.S. car exports would impact nearly 270,000 U.S.-made vehicles. German carmakers account for the vast majority of cars, luxury models for the most part, shipped to China from the United States.[7]

On a side note, many analysts have argued that by attacking the trade policies of the EU (and Canada for that matter), the United States has missed a valuable opportunity to forge an alliance against China's trade practices. Similar to the United States, the EU has long complained about China's closed economy, which includes their companies being pressured to share technology in exchange for market access.

The United States and the EU have very different world views

This trade dispute is part of broader tensions between the United States and the EU that include clashes over low European defence spending, immigration policy, and U.S. withdrawal from both the Paris global climate treaty and the Iranian nuclear accord.

Indeed, these tensions have led President Trump to challenge Chancellor Merkel in an unprecedented public manner. "The people of Germany are turning against their leadership as migration is rocking the already tenuous Berlin coalition," he recently tweeted.

However, it is important to note that, while many Europeans do hold a negative opinion of President Trump, he is not completely isolated in Europe. His worldviews are shared in part by the Eurosceptic governments of Hungary, Poland, Italy and Austria, particularly with regards to immigration.

[4] "Donald Trump's trade war with Europe looks inevitable," Financial Times, April 29, 2018
[5] "As EU plans retaliatory tariffs on US, Germany fears the fallout," Handelsblatt, June 8, 2018
[6] "Ranking of Germany's trading partners in foreign trade," Statistisches Bundesamt (German government), May 22, 2018
[7] "China-U.S. trade war hits Daimler profit, may sweep sector," Reuter, June 20, 2018

Europe's many other challenges

This trade dispute with the United States comes at a time when the EU is already having to struggle with many other challenges:

- The risk that the minority German government, led by Chancellor Merkel, collapses over the issue of immigration. Regardless of the outcome, a Germany preoccupied by its increasingly fragmented political landscape has less political capital to solving Europe's challenges.
- The continued drop in support for traditional European mainstream parties at the expense of growing support for parties on the far right and left of the political spectrum. The most recent example of this is the election of a Eurosceptic Italian government angry over illegal immigration and EU-imposed fiscal austerity.
- Growing tensions with Hungary, Slovakia, Poland and the Czech Republic over issues ranging from state restrictions on the media and the judiciary to the resettlement of refugees. All of these eastern European countries are led by Eurosceptic governments.
- Ongoing Brexit negotiations that appear stuck between the inability of the UK minority government to agree on a coherent negotiating position and the EU's hardline stance regarding market access.
- The view that the euro zone will be able to function properly over the long term only with a fiscal union and/or Eurobonds must be reconciled with the growing sentiment among the European electorate that integration has already gone too far.
- Continued instability in the Middle East and Africa, which is the main driver of illegal migration.

An economic slowdown would only increase the difficulty of managing these challenges.

Conclusion

President Trump's recent invitation to European Commission President Jean-Claude Juncker to visit the White House suggests that trade negotiations between the two parties could soon resume. However, Trump's insistence on the elimination of all tariffs on motor vehicles and the fact that changing EU tariffs requires the approval of all 28 members could make for very tough negotiations.

When it comes to the business climate, the plight of Harley-Davidson exemplifies the difficult position many companies will find themselves in due to increasing trade tensions. On the one hand, the fact that EU tariffs will add an average over $2000 to the cost of each U.S.-made Harley sold in Europe means it makes financial sense to shift some production outside of the United States. On the other hand, the political blowback from transferring production abroad could mean lost sales from angry Americans and more attacks by Trump. The following tweet being a case in point.

"A Harley-Davidson should never be built in another country-never! Their employees and customers are already very angry at them. If they move, watch, it will be the beginning of the end - they surrendered, they quit! The Aura will be gone and they will be taxed like never before!"

This highlights the importance of investors going beyond simply analyzing a company's fundamentals to looking at how ongoing or potential future trade-related tensions could significantly impede access to key markets.

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