The US escalated the trade conflict. Regarding China, US President Trump implemented a 25% tariff on US$34 bn of imports from China and plans to target US$16 bn soon. Moreover, most recently the US administration threatens a 10% tariff on further US$200 bn of imports from China.

On June 22, US President Trump threatened a 20% tariff on car imports based on national security grounds. The investigation could last until February 2019. Outside NAFTA, the EU and Japan would be hurt the most.

Tariffs on cars would affect 10% of euro area and 30% of Japanese exports to the US. The drop in exports alone could dent Germany’s and Japan’s GDP by up to 0.4% of GDP. Lower imports of intermediate goods would mitigate the impact while damage to the supply chains and to sentiment would work in the opposite direction.

The EU has pledged to retaliate and already prepared a list of imports covering US$300 bn. Given the substantial damage inflicted by an escalating trade war, however, we would not already dismiss the chances of a settlement.

Financial markets have already incorporated increased tensions from trade but in the near term may continue to be dampened by the uncertainties surrounding the evolution of the trade conflict.

Over the past weeks, the US escalated the trade conflict. Regarding China, US President Trump implemented a 25% tariff on US$34 bn of imports from China and plans to target US$16 bn soon. Moreover, most recently the US administration threatens a 10% tariff on further US$200 bn of imports from China.

On June 22 – the day the EU imposed a 25% tariff on €2.8 bn of US imports in response to the US tariffs on steel and aluminum – Trump reiterated the threat of a 20% tariff on all US imports of cars. Formally, the investigation into tariffs on cars had already been launched under Section 232 of the Trade Expansion Act, which covers national security reasons, on May 23. This covers not only cars but also light trucks, SUVs and automotive parts and could last until February 2019. In case a threat for national security was to be detected all but not only the imports from the EU would be affected. As Mexican and Canadian car exports are part of NAFTA renegotiations currently underway, new tariffs on cars would primarily target Japan and the EU (Germany), being among the four biggest car exporters to the US.

In what follows we discuss the effects of tariffs on cars for the euro area and Japan and assess the implications for the risk of a trade war and financial markets.

### The rationale behind US tariffs on cars

In his election campaign, Trump had focused on the US trade deficit that he considers to be the outcome of unfair trade practices of the partner countries. About 20% of the US trade deficit of around $800 bn is due to a deficit in automobiles.

Taking a deeper look into the trade between the US and the EU resp. Japan, the US does not run a deficit in all goods. However, the one on motor vehicles is quite substantial. It includes apart from cars also other vehicles...
like trucks. In case of the euro area it amounted to €89 bn in 2016, compared to the total deficit in trade with euro area of €97 bn. Looking into to the trade partner countries, this deficit was largely due to a German surplus. In case of cars which intend to be targeted by the US tariffs, the German surplus of €16.3 bn made 71% of the euro area surplus. A balanced trade in cars would reduce the euro area trade surplus from €107.3 bn in 2017 to €84.4 bn. The Japanese economy is also very exposed to the exports of transport equipment (statistics compared to the EU are slightly different). Exports of the sector to the world account for 23% of total exports, of which motor vehicles are responsible for about 15% and auto parts for another 5%. The exposure to the US is even higher. Here exports of transport equipment has a share of 40% of all exports to the US, of which motor vehicles are 30%. By contrast, the import side looks tiny. Transport equipment (motor vehicles) amounts to 4.2% (1.7%) of all imports, in case of the US to 6.6% (1.1%). Consequently, the impact on the trade balance is significant. The trade surplus to the US (to which transport equipment contributed 78%) was considerably higher than the overall Japanese trade surplus, in fact 2.4 times higher. The overall balance is lower, mainly due to large energy imports from the Middle East. Nevertheless, to put these numbers into perspective, Japan’s merchandise exports and imports account for around 13%-14% of GDP, and the trade surplus to only 0.77% of GDP. The transport equipment surplus to the US is responsible for about 1% of GDP.

Regarding the reasons behind the US trade deficit in cars, Trump has a point in stating that there is no plain level field. The applied Most Favored Nation (MFN) tariff of the EU on vehicles is 6.2% but in case of the US it is only 3.1% and generally tariffs are lower in the US than in the EU and Japan, especially for agricultural products. However, in case of Japan the average tariff on vehicles is only 0.1% but the bilateral trade deficit is still huge.

### Tariffs on cars: negative effect on growth

A rationale behind US tariffs on cars is that initially – meaning before the trading partners would react by means of retaliation – there is leeway for the US trade balance to improve albeit we would still expect it to stay negative while growth in the trading partners’ economies would definitely suffer.

To assess the effect of a tariff on US imports quantitatively, the price elasticity on the US car market is key. The market price elasticity estimates for the US market vary between -0.8 and -2. The literature suggests a relatively high price elasticity for more expensive cars like the German ones. Moreover, as the tariff only concern a part of the total US car market (i.e. imported cars), the fall of demand for foreign cars would likely be even higher. In order to assess the effect of a 20% tariff we deem a range of -0.8 to -3 for the price elasticity sensible.

Within this setting and depending on the elasticity, the proposed US tariff on cars could reduce the deficit in car trade in case of the euro area between US$ 6 bn and US$ 21 bn (i.e. by -0.2 pp to -0.1 pp of euro area GDP) and in the Japanese case by US$ 8.2 bn to US$ 20.5 bn (i.e. by 0.17 pp to 0.42 pp of Japan’s GDP). The US trade deficit with Japan and the euro area would fall by up to $50 bn thereby reducing the trade deficit for vehicles (SITC basis) to $120 bn. In case Trump would manage to negotiate equivalent measures with the NAFTA partners Mexico and Canada as well as taking into account also the effect of car tariffs on the remaining car exporting countries, the US goods trade balance could improve by up to $110 bn or 0.6 pp of GDP (from -4.2% in 2017 to -3.6%). It seems to us that it is this naïve and static way of thinking that can also easily be communicated in election campaigns standing behind Trump’s aggressive stance on tariffs.

Given the importance of car exports for Japan and Germany, growth in these economies would be significantly damped. In case of a strong reaction (elasticity -3) German and Japanese GDP would suffer by 0.4% whereas euro area output would only be reduced by 0.2%. Given that Japan growth is expected around 1% in this year and the next, this impact looks significant.

This simple approach, however, clearly ignores second-order economic effects. On the one hand, given that a significant part of intermediate goods used in the production of cars need to be imported, the negative effect on GDP is partly offset by lower imports. According to OECD data the import content of exports is 25% in case of Germany and 18% in case of Japan which would mitigate the fallout from tariffs. On the other hand, there are also various factors aggravating the effect on activity. In Germany for instance, almost 2 million jobs directly or indirectly depend on the car industry and higher unemployment would clearly burden domestic activity. Globally, a disruption of international supply chains would also dampen activity.

Most important in our view is the effect from tariffs on sentiment and uncertainty. Until June, sentiment in the
German as well as euro area car industry stayed firm at levels still above normal with export expectations showing no turn to the worse either. At the same time uncertainty about US trade policy increased sharply. Economically, trade agreements also serve as insurance against demand uncertainty. If the existing agreements are increasingly put into question or changed to the worse, firms will be more cautious on investment spending. All in all, we expect a significant negative effect on growth in case the implements the proposed tariffs on cars.

Financial markets priced risk of tariffs on cars

Looking ahead, however, markets will have to assess the risk of a further escalation of trade tensions. The related uncertainty has already started to impact the real economy, mainly through dampened sentiment and potentially adverse effects on capex spending. In July, the ZEW index for Germany reflecting economic analysts’ expectations deteriorated strongly (by -8.6 index points to -24.7, the worst since August 2012), albeit the German June composite PMI gave quite positive signals.

The looming risk of car tariffs has already left its mark on financial markets even more clearly. In equities the automobile sector has underperformed the index in Europe, Germany and Japan. Since the start of Q2, the MSCI EMU advanced by 5% whereas the auto sector receded (by -6.9%). Earnings expectations for the sector have been adjusted downwards. In credit derivatives markets, the CDS of European car producers deteriorated relative to its US peers whereas this has not been the case for Japanese firms yet.

As markets have incorporated the risk of car tariffs, it seems that their outright implementation is not fully priced in according to our calculations. In such a case we would see the need to adjust our euro area and Japanese growth forecasts (2018: 2.0% / 1.0%; 2019: 1.7% / 1.1%) to the downside. We would see leeway for European equities to suffer by about 5% to 7% with shares of car producers and related firms suffering the most. At corporate bond markets we would expect the spreads of car producers against other companies to widen more meaningfully.

Overall, we acknowledge that the market has priced in already trade war worries so that currently the risks look fairly balanced. We recommend adopting a cautious stance over the summer months.

Risk of a trade war increased

If the US were to introduce tariffs on cars, the affected partner countries would very likely retaliate. In the case of steel and aluminum tariffs the EU responded by bringing the case to the WTO while at the same time adopting safeguard measures and protecting the market from trade diversion. The EU has already prepared a list of imports covering USD 300 bn. The Japanese PM Abe said, he “cannot accept” new tariffs on autos, but remained rather reluctant to announce any counter-measures. By contrast, the Chinese government announced to retaliate the recently threatened new import tariffs for Chinese products (10% on imports of $200 bn). The crucial question is whether the spiral of new tariffs and retaliation will stop somewhere or whether we will ultimately end in a global trade war.

Here, President Trump holds the key. In our view, his primary objective is to bring back to and secure jobs in the US in order to please his electoral base. He does so with a look at the Midterm elections in November but probably also has the next Presidential election in 2020 in mind. As long as his policy secures or increases his approval rate he will likely continue pursuing an aggressive trade policy. However, a recent study by the Peterson Institute estimates that in case car tariffs are being retaliated – as we expect – 624k jobs would be lost over a 1 to 3 year horizon while production would fall by 4% in the US car industry.

That said, we are not there yet. The US economy is doing very well, not least boosted by the tax reform. Taking the imposition of tariffs on steel and aluminum as a blueprint, Trump will probably decide on tariffs even before the formal investigation period ends at the latest, namely February 2019. If he were to do so, we would expect some stepping back only once the negative effects on the US economy become visible. However, there is still a chance to find an agreement before implementing tariffs on cars. For instance, the US proposed to scrap all tariffs on cars to the EU and the idea of a TTIP light with all tariffs in transatlantic trade being eliminated has also come to the fore. Business leaders from both sides of the Atlantic as well as the Pacific will probably pressure their governments to find an agreement. The fact that EC President Juncker will meet Trump next week in order to explore the possibility to reduce car tariffs is encouraging. Therefore, we would not already dismiss the chances of a settlement.