Trump's auto-tariffs threat: trade linkages and market implications

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- Aside from ongoing US-China trade talks, by 18 May, the Trump administration will have to decide whether to impose new tariffs on EU car imports, with the possibility to postpone a decision until 14 November.
- From a US perspective, higher car tariffs are seen as an appropriate measure to curb a widening US trade deficit with the eurozone, as half of it is due to bilateral trade imbalances in cars and vehicles parts.
- However, such a simplistic approach to trade issues ignores the degree of value chain integration of the two markets: 25% of eurozone auto-related exports to the US are used as intermediate inputs by US firms, and they roughly represent 10% of the value of US-produced vehicles.
- In terms of their effect on markets, higher car tariffs (if they are imposed or just postponed) are likely to trigger a temporary tightening in overall financial conditions in the eurozone, with stock prices in the auto sector probably taking the strongest hit.

While all eyes are currently on US-China trade talks, another deadline on 18 May looms, when US President Donald Trump is expected to announce his decision on whether the US is going to impose higher tariffs on imported EU cars due to national security reasons. The importance and vehemence of this decision became clear as a result of one of Mr. Trump's latest statements. In late February, during a meeting at the White House on the future of US trade policy, he stated that "[t]he European Union is one of the toughest – maybe the toughest. Maybe, in certain ways, tougher than China, just smaller, from our standpoint. But they have to meet. And we told them, 'Have to meet. Sorry. And if you don't meet, we're going to tariff the hell out of you.'"[1]

A week before this, on 17 February, the US Commerce Department had submitted to the president its report and recommendations with regard to imports of cars and vehicle parts. The details of this report have not been disclosed yet, but according to Section 232 of the Trade Expansion Act of 1962 (see the box for a brief overview of this procedure), which authorizes the president to curb imports that threaten national security,[2] Mr. Trump has until 18 May to decide whether to raise tariffs on cars from the EU – up to 25% from their current 2.5%.[3] If a decision is not taken by then, the threat of new tariffs would weigh on sentiment and economic activity beyond the 18 May deadline.

According to Section 232 of the Trade Expansion Act of 1962, Mr. Trump may decide to negotiate better trading conditions for the car sector with the EU. In that case, he would be allowed to push back the decision deadline by an additional 180 days. This would postpone the cutoff date to 14 November.

There are three possible outcomes: **1.** Higher tariffs are not imposed. **2.** Higher tariffs are announced by 18 May and imposed within 15 days. **3.** The final decision is postponed to mid-November. The first scenario would bring immediate relief to financial markets and in turn to the real economy. The second scenario would dampen demand for the eurozone's auto industry and have a negative impact on overall economic activity, with the risk that the US would be affected to an even greater extent than the eurozone. According to our last study on the direct impact of additional tariffs on EU cars (see Economics Thinking – US tariffs: estimating the cost to European industry), an increase of up to 25% would lower EU GDP by 0.2%, with the cost amounting to around EUR 8.4bn, of which more than 70% would be borne by the German car industry.[4] The third scenario implies that Mr. Trump would use the threat of new tariffs for a prolonged period as a bargaining chip to negotiate a trade deal with the EU that fictitiously promotes US interests ahead of presidential elections without necessarily imposing any additional duties in the end.

Box: how a Section 232 procedure works

The Trade Act of 1962 was enacted during the Cold War, when national-security issues were at the forefront of government concerns. According to this act, the head of any US government department or agency may request, by application or by self-initiation, that the secretary of commerce commence a Section 232 investigation. The Department of Commerce then has 270 days from the initiation date to prepare a report on whether the product in question is being imported in such quantities or under such circumstances so as to threaten to impair US national security. Recommendations for action or inaction based on findings are also required to be provided in the report. The statute does not specifically define national security. The president may implement the recommendations suggested in the report, take other actions or decide to take no action. After making a decision, the president has 15 days to implement the action and 30 days to submit a written statement to Congress explaining the action or inaction; the president must also publish his or her findings in the Federal Register. However, he or she can also launch negotiations to limit imports and defer new trade restrictions for up to 180 days while talks are proceeding.

[1] https://www.whitehouse.gov/briefings-statements/remarks-president-trump-2019-white-house-business-session-nations-governors/

[2] The US code does not define the concept of national security, giving latitude to the Commerce Department in the scope of the investigation.

[3] European tariffs on US cars stand at 10%, although non-tariff barriers, such as technical standards or regulations, are higher in the US.

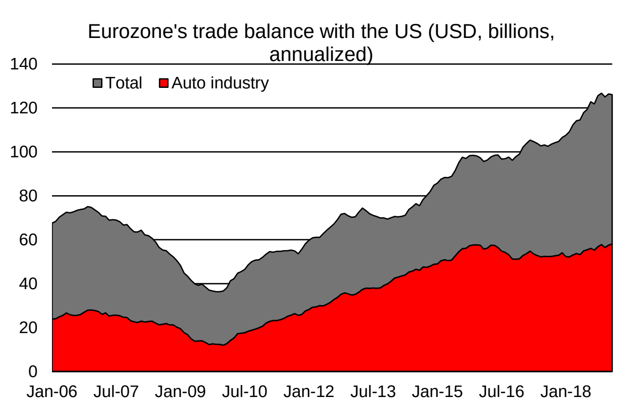
[4] If Mr. Trump eventually decides to impose new tariffs, these would cover auto-related goods produced across the EU. However, since Germany would be most affected, we have restricted our analysis to the eurozone.

In the following, we examine the trade relationship between the US and the eurozone in terms of the car sector and show how interconnected the two markets are. We explain why higher tariffs might act as a double-edged sword, economically and politically. For this reason, there is a non-negligible probability that the third scenario might materialize as Mr. Trump would be able to use the threat of higher tariffs to finalize a trade agreement with the EU, without alienating US auto producers, who strongly depend on intermediate goods from Europe. Lastly, we will discuss the market implications of the second and third scenarios and show that only auto-related asset prices are likely to be affected, whereas the total market impact should remain contained.

The car sector behind the widening trade surplus

This Section 232 investigation is a component of the Trump administration's broader agenda, which includes the following: **1.** expanding domestic auto manufacturing and domestic content in autos, **2.** addressing bilateral trade deficits and **3.** reducing disparities in US and trading-partner tariff rates. The rationale for this specific investigation is the wide imbalance in US trade in motor vehicles and automotive parts with the EU in general and with the eurozone in particular. As Chart 1 shows, the eurozone's trade surplus with the US has continued to rise since the financial crisis and is now almost triple what it was before the crisis. It now stands at around EUR 120bn (on an annualized basis). Roughly half of this is represented by a bilateral trade surplus in cars and vehicles parts, which since 2015, has stabilized around EUR 48bn. By taking a very simplistic approach to trade issues, then, one could argue that higher tariffs on car-related imports would reduce the US trade deficit with the eurozone while favoring domestic production. However, as we discuss in the next paragraph, this ignores how value chains work in a highly-integrated global economy.

CHART 1: A WIDENING SURPLUS



Source: Eurostat, UniCredit Research

A double-edged sword

Along with agriculture and public procurement, auto-sector trade imbalances are such a thorny issue that Washington and Brussels decided to exclude them from negotiations that started last July after Mr. Trump and European Commission President Jean-Claude Juncker agreed to work together towards achieving zero tariffs, zero non-tariff barriers and zero subsidies on non-auto industrial goods. At the time, Mr. Trump and Mr. Juncker agreed to focus on a limited range of areas where results could be realistically achieved quickly and without touching on areas of significant sensitivity for either side. Mr. Trump also promised not to impose any protectionist measures on the auto industry while negotiations were underway.

Avoiding to open the Pandora's Box of auto tariffs was probably more in the interest of the US than in the interest of Europe. Mr. Trump is probably aware that tariffs on the auto industry represent a double-edged sword politically. Although US tariffs on cars from the EU amount to 2.5%, this figure excludes light trucks, a category that comprises pickup trucks, minivans and SUVs. For these vehicles, the EU duty is also 10%, while the US imposes a 25% tariff – a legacy of the Johnson administration, this rate was imposed in 1963 during the Chicken War between the US and various European countries. As pointed out by UniCredit US economist Harm Bandholz[5], given that light trucks now account for 70% of all motor-vehicle sales in the US, the theoretical weighted-average tariff for EU motor-vehicle exports to the US is 18¼%, compared to a 10% duty for US auto exports to the EU. This 25% "chicken tax" explains why foreign carmakers tend to produce their SUVs and pickup trucks in the US. Talk of eliminating duties in this sector therefore needs to incorporate duties levied on light trucks. Thus, the European Commissioner for Trade Cecilia Malmström proposed last summer that the EU is "willing to bring down even our car tariffs to zero, all tariffs to zero if the US does the same."

Moreover, Mr. Trump does not want to anger auto dealers, which represent a powerful US constituency. According to a study by the Center for Automotive Research,[6] additional tariffs of 25% being applied to all vehicle and parts imports would increase the average consumer price of vehicles sold in the US by up to USD 4,400. Furthermore, it would lower sales by 2mn vehicles per year and thus cost new-vehicle dealerships around USD 60bn in annual revenue. The total impact of such a scenario on US employment would result in the loss of more than 700,000 jobs.

[5] https://www.gaccny.com/fileadmin/ahk_gaccny/Communications/Publications/GAT/2019/GA_Trade_Q2_2019_interactive.pdf

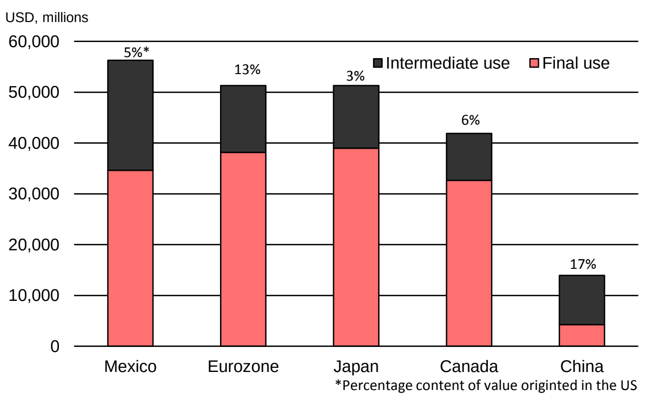
[6] Schultz, M. et al. (2018), Consumer Impact of Potential US Section 232 Tariffs and Quotas on Imported Automobiles & Automotive Parts, Center for Automotive Research, July 2018.

These high costs for the US are due to the high degree of integration between the value chains of the two markets. Chart 2 focuses on the top-5 trading partners of the US (Mexico, Canada, the eurozone, Japan and China) and shows a breakdown of exports of cars and auto parts to the US into goods that are directly sold to US consumers or that are used as intermediate inputs by US firms.

Overall auto-related exports from the eurozone amount to USD 51bn, which is slightly less than what Mexico ships to the US. However, the value of eurozone exports to the US that are directly consumed without requiring any further transformation is second only to Japan, albeit by a rather thin margin.

In order to understand the degree of integration of the two regions, instead, it is important to focus on exports that are used as intermediate inputs within the value chain. Eurozone exports to the US for intermediate use amount to around one-fourth of total exports. In dollar terms, this amount is lower than it is for Mexico but is broadly in line with Japan's figure. At the same time, the US-originated content of Eurozone car exports to the US amounts to roughly 13%. This is the highest percentage among trading partners except for China (17%).

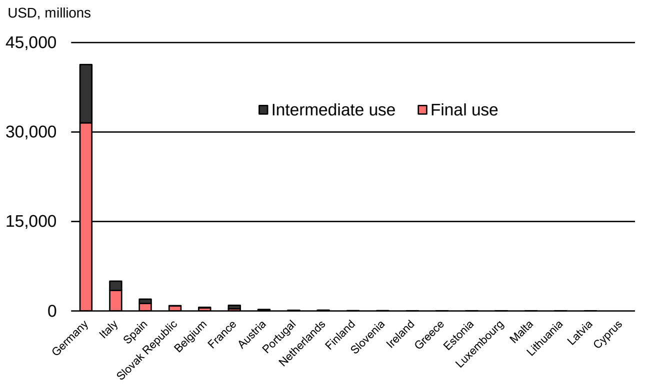
CHART 2: EXPORTS OF CARS AND PARTS TO THE US



Source: World Input-Output Table, UniCredit Research

With regard to the origins of eurozone car exports to the US by member country, almost 70% come from Germany (USD 42bn), followed by Italy (USD 6bn) (see Chart 3). This significant share of German car exports to the US suggests that the US trade dispute with the EU is actually aimed at Germany, which increasingly seems to be considered by Mr. Trump as a geostrategic rival rather than a longstanding ally.

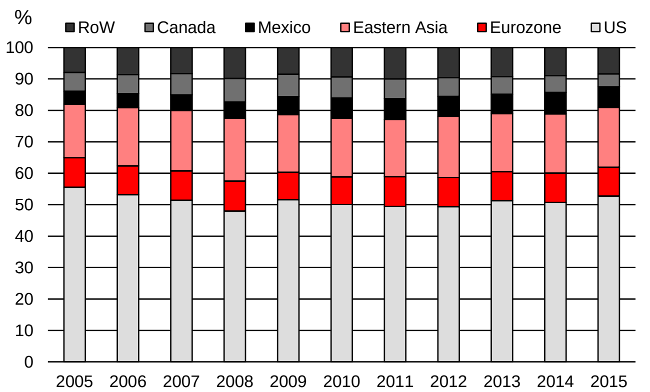
CHART 3: US CAR IMPORTS BY EUROZONE COUNTRY



Source: World Input-Output Table, UniCredit Research

The high degree of integration of the value chains between the EU and the US is also clear from another perspective. Sales of US vehicles are composed of imported value added (47%), with some assemblies crossing borders several times (see Chart 4). Eurozone exports represent roughly 10% of the value added to US vehicles sold to American consumers. Therefore, tariffs on eurozone exports would not only hurt US consumers but would also harm US car producers, whose costs for intermediate inputs would go up. In addition, any fall in sales of EU cars would induce EU producers to import fewer intermediate goods from the US, thereby harming US producers twice. This explains why, last July, a bipartisan group of 149 US congressional representatives sent a letter to the Department of Commerce seeking to end the Section 232 investigation. The US car industry has also voiced strong opposition to tariffs and advocated from a united position at the Department of Commerce's hearing on the subject.[7]

CHART 4: ORIGIN OF VALUE ADDED OF US-PRODUCED CARS



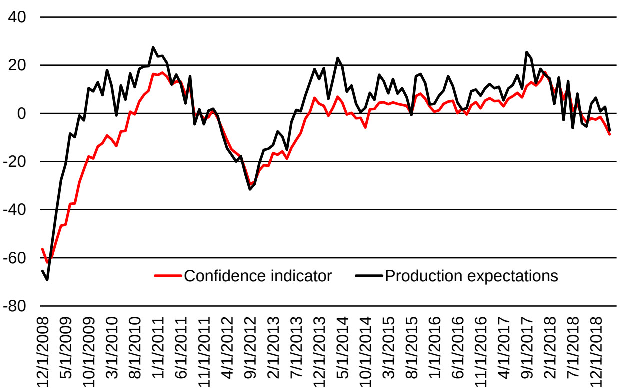
Source: OECD, UniCredit Research

[7] See *Section 232 Auto Investigation*, Congressional Research Service, 24 October 2018.

The financial dimension of higher tariffs

The uncertainty surrounding the EU's future trade relationship with the US has weighed on sentiment towards the eurozone's car industry. This had already been dampened by the introduction of a new car-emissions testing procedure, falling demand in key export markets and uncertainty arising from the structural shift away from internal combustion engines to electric-drivetrain technology (which requires a strong increase in R&D expenses). A survey by the European Commission has shown that production expectations pertaining to the eurozone's car sector closely follow trends in eurozone car-sector confidence, which has been declining since January 2019 and no longer shows signs of stabilizing (Chart 5). Falling confidence among automakers is adding to more-generalized weakness in the manufacturing sector across the eurozone.

CHART 5: EUROZONE CAR MAKERS' CONFIDENCE CONTINUES TO FALL



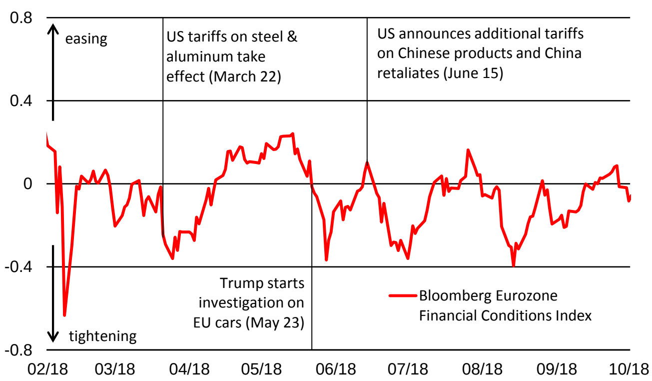
Source: Eurostat, UniCredit Research

The threat of higher tariffs has had a negative effect on confidence and on financial markets in general. Uncertainty about future trade regimes in general, confidence effects and adverse financial spillovers may amplify adverse effects on asset prices. Uncertainty about trade policies could increase risk premiums and trigger a more fundamental reassessment of stock and corporate-bond prices. The associated tightening of financing conditions would negatively affect investments (through increases in the cost of capital). In addition, higher tariffs may alter the allocation of productive resources across firms, with domestic market share being reallocated towards less-efficient domestic producers, which would lower aggregate productivity.

Chart 6 shows that escalatory trade announcements and the introduction of tariffs have significantly deteriorated financial conditions in the eurozone, but their impact tends to be short-lived. In March 2018, the implementation of tariffs on steel and aluminum triggered a tightening in financial conditions.

This tightening became even more pronounced when, on 23 May 2018, the Trump administration initiated the Section 232 investigation on auto-related goods. Even announcements that are not directly targeted at eurozone countries, such as the June 2018 escalation of US-China trade relations, have led to substantial tightening in eurozone financial conditions. Consequently, should tariffs on eurozone vehicles and auto parts be implemented, an even more pronounced deterioration in financial conditions could follow and negatively affect investment via an increase in the cost of capital.

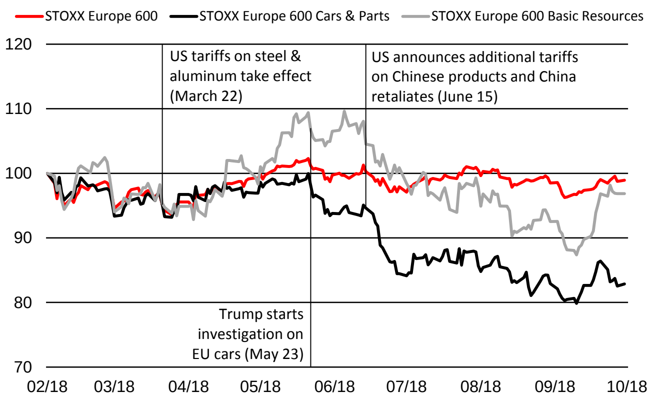
CHART 6: EUROZONE FINANCIAL CONDITIONS



Source: Bloomberg, UniCredit Research

Similar effects can be observed among equities. Equity prices in sectors most exposed to tariffs have underperformed, whereas overall equity indices have tended to remain broadly unchanged. These negative financial spillovers are transmitted through two channels: directly (through lower corporate earnings and higher credit risk) and indirectly (through higher uncertainty and adverse effects on international investors' confidence). While the first US tariff announcements in March 2018 did not have a sizeable impact on European equities, the escalation of the US-China trade dispute in June 2018 led to a substantial drop in the prices of equities in both the basic resources and automobile sectors, which face additional pressure as a result of structural changes (see Chart 7).

CHART 7: EUROPEAN EQUITIES (2 FEB 2018 = 100)



Source: Bloomberg, UniCredit Research

Car stocks did not recover in the subsequent months and appear set to take another sharp plunge if the Trump administration implements tariffs on EU cars later this month. A number of headwinds specific to the auto industry have contributed to its underperformance. By comparison, the steel and aluminum markets, despite showing massive volatility, have recovered much lost ground – meaning that underperformance in targeted sectors tends to be short-lived when no other factors pose a drag.

Concluding remarks

By 18 May, Mr. Trump is expected to decide whether or not to impose higher tariffs on the EU's automobile and car parts sectors. We have previously highlighted the impact of higher tariffs on eurozone GDP. In this issue, we focus more on the financial impact of such tariffs. Since tariffs on the auto industry are a thorny political issue for Mr. Trump, it is likely that they will be used as a bargaining chip until the end of the year in order to force Brussels to offer better trade terms. In this case, and as long as no additional products are targeted by Washington, the threat of higher tariffs should primarily weigh on confidence and asset prices in the car sector and have a limited impact on markets in general. Only an escalation in trade tensions, involving more regions and a broader basket of goods, would lead to a more generalized repricing of assets.

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