

Trade War on the Horizon

How Should the EU React?

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The protectionist trade policy Donald Trump had already announced during his election campaign has been taking more and more concrete shape since March 2018. Although the European Union (EU) had initially been exempted from punitive tariffs, the U.S. government imposed tariffs on steel and aluminium from EU countries effective June 1, 2018. The protectionism emanating from the U.S. threatens to escalate further. How should the EU respond?

Protective tariffs harm your own economy

Time and again, individual countries try to protect their less competitive sectors from foreign competition by restricting imports. In the short term, import restrictions might benefit the protected sector. For the entire economy of the country, however, this protection is a losing business.

When the United States, for example, imposes protective tariffs on foreign products, these tariffs can harm American consumers and companies in several ways:

1. If U.S. consumers continue to buy imported products, they have to pay a higher price, which reduces their purchasing power. As a result, they have less money to spend on domestic goods, and, therefore, overall demand for U.S. products falls.
2. Even if U.S. consumers switch to domestic products, they still have to pay a higher price than before the import duty. U.S. products only seem competitive compared to imports because of the new tariff. Due to labor and other costs in the United States, U.S. companies still need to charge higher prices than many companies abroad.
3. The general price increase also affects the intermediate inputs – the parts a company purchases elsewhere, e.g. an engine that a car manufacturer does not produce itself – used by American companies in their production processes, which increases the costs of production in the United States. The consequence is a reduction of the competitiveness of American companies, which decreases demand for U.S. exports in the rest of the world.

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4. If both private consumer demand and exports decline, this will have a negative impact on investment behavior: Lower demand for American goods and services reduces the incentive for companies to expand their production capacities. As a result, investment in the U.S. declines, forcing American companies to reduce production and employment.

5. Finally, easing competitive pressure weakens productivity growth and structural change. In the long term, this will reduce the long-term growth of the American economy.

No one wins a trade war

These five harmful effects alone suggest that U.S. punitive tariffs are damaging to the domestic economy as a whole. The economic damage will be even greater if the economies affected by these tariffs also react with reciprocal trade policy measures, which is inevitable.

When U.S. trade policy makes it difficult to import European products, EU retaliation has further negative economic consequences for the United States:

- European import tariffs on U.S. products cause a decline in U.S. exports to Europe, which has the already-outlined negative effects on production, employment, income, and investment in the U.S.
- Decline in U.S. income reduces domestic demand for goods and services from the rest of the world, i.e. U.S. imports shrink. This also applies to U.S. imports from Europe; hence European exports decline. As a result, production, employment, and income begin to fall in Europe.
- A lower income in Europe restricts the demand for goods and services in Europe, which further reduces the export possibilities of the United States.

Overall, by introducing import tariffs the U.S. is worsening its own export prospects and thus weakening growth and employment within its borders.

Of course, the developments outlined also apply to Europe and the EU: If the EU reacts to U.S. protectionism by imposing corresponding import tariffs on U.S. products, the same unintended growth and income reducing side effects will occur in Europe.

As a result, a “trade war” – the increasing spiral of protectionist measures and countermeasures – between the U.S. and Europe leads to a decline in production, income, and employment in both regions. Given the size of these

two economies, this economic downturn also damages economic development in the rest of the world.

Such economic development has no winners, only losers.

How should the EU react?

The aim of all European efforts should be to free global cross-border trade as far as possible from discriminatory barriers to trade. At the same time, U.S. protectionist measures directed against the EU should not remain unanswered, but be answered with moderate retaliatory measures.

To maintain its free trade objective, the EU has five fundamental starting points for responding to the U.S. administration’s current shift towards economic isolationism and any resulting global trade conflict.

1. Reduction of European trade restrictions vis-à-vis all WTO partners

First of all, the EU should strengthen its call for trade to be as free as possible by removing its own barriers to trade against World Trade Organization (WTO) members. It is highly likely that this will not deter the U.S. administration from its protectionist stance towards the EU. This measure is therefore not primarily aimed at “appeasing” the United States. The purpose of removing existing discriminatory trade restrictions is rather to show the rest of the world that the EU takes seriously its commitment to free trade worldwide – even, and especially, in times of increasing protectionism.

One thing must be clear: a unilateral reduction in import tariffs on American products is not possible. The rules of the World Trade Organization require that tariff facilitation granted by a WTO member to another WTO partner country must apply to all WTO countries (most-favoured-nation principle). Therefore, the EU cannot provide special trade concession to any trading partner.

2. Strengthening of the European internal market

A decline in the EU’s export prospects due to a protectionist course taken by the U.S. or other countries will weaken Europe’s economic development, and above all its foreign sales. To compensate for lower exports, EU members could expand the European internal market.

The single market and increasing EU integration have had a positive impact on the economic growth of all EU Member States in the past (see Petersen, T., M. Böhmer and J. Weisser 2014). However, the completion of the EU internal market is far from complete. National borders still play an important role in areas such as trade in services, cross-border labor

mobility, and public procurement. The online market for goods and services within the EU also offers far-reaching potential for strengthening the EU internal market.

If we consider the EU as one economy, strengthening its internal market would increase domestic demand, boost economic growth in the EU, and, therefore, also stabilize employment. As the risk of an escalation of current trade disputes grows, the EU's single market should be strengthened quickly in order to be better prepared for impending export collapses.

3. Support for multilateralism within the WTO

The World Trade Organization (WTO), which sets the norms and framework for the multilateral trade system, must continue to fulfill two important functions. First, it must retain its role as the forum for solving trade problems (e.g. overcapacity in the steel industry). Second, its dispute settlement process must be respected as the most important element of international law in order to avoid an escalation of trade disputes.

Both WTO functions are currently only functioning to a limited extent. The EU supports a resurgence of the WTO and has committed itself to the WTO as part of its trade strategy "Trade for all" (see European Commission 2015) and has called for an enhanced role of the multilateral trade system. Moreover, in its reactions to U.S. punitive tariffs, the EU refers firmly to WTO law and ensures that its countermeasures respect international rules.

A reform process in the WTO is a lengthy one, however, one that also requires difficult compromises from everyone involved. Nevertheless, it is important to defend and further develop the liberal, rule-based order of the world trade system. Only in the multilateral trading system can the fairness requirements for trade be satisfactorily enforced, and disadvantages for small and medium-sized economies avoided.

4. Completion of regional trade agreements

From a welfare theory perspective, regional free trade agreements are only the second-best solution compared with the preferred agreement, multilateral free trade. An intensification of trade relations between the member states of a regional agreement goes hand-in-hand with income and employment loss in third-party countries through trade diversions.

Nevertheless, if a multilateral deal is not possible, regional free trade agreements are still better than no agreements at all. It is also quite plausible that countries which are not part of the bilateral agreement in question, for their part, attempt

to stimulate growth and employment through stronger economic cooperation with regional partner countries. Regional free trade agreements can thus lead to greater regional economic integration among the other economies outside of the free trade deals. In this way, regional free trade agreements would serve as a boost and not as a brake on stalled multilateral negotiations.

Such agreements must incorporate the high standards and protection standards that the EU has already achieved, particularly with regard to consumer protection, environmental protection, employee protection, and social security standards. The EU must not abandon these standards of protection achieved when they establish new regional free trade agreements, as they are an integral part of a social market economy.

5. Moderate retaliation against the U.S.

Since the U.S. imposed punitive tariffs directed against EU products, the question has arisen as to whether the EU should react with retaliatory measures and, if so, to what extent?

There is no consensus in science and politics on how to answer this question. Rolf Langhammer, a German trade expert at the Kiel Institute for the World Economy, argues in favor of simply ignoring U.S. punitive tariffs. Instead of closing the market to U.S. products, the EU should focus on a strategy of market opening and unilaterally reduce its import duties - like China has done in retaliation of the July 1, 2018 duties on cars (see Langhammer 2018). Ultimately, political and economic decision makers in Europe fear that EU retaliation will lead to an escalation spiral, as the U.S. administration does not seem willing to give in and would react to tariffs with further tariffs. The end of such a "tit-for-tat strategy" would, therefore, be completely unforeseeable.

On the other hand, there are also voices that accept a weakening of the European economies by imposing punitive tariffs of their own and demanding punitive tariffs against the United States, arguing that this is the only way to build up pressure on the U.S. administration. Since pointing out the advantages of multilateral and rule-based world trade will not dissuade the Trump administration from its protectionist stance, the EU must stand up to the Americans and respond with punitive tariffs (see Fratzscher 2018). Even if these tariffs do not immediately induce the Trump administration to reverse trade policy, political pressure can still be exerted. Within the EU, this strategy is represented by the EU Commission and countries such as France and the Netherlands.

Due to the disagreement of Europeans, the Commission has proposed a differentiated and gradual response to

U.S. tariffs. The punitive tariffs currently imposed by the EU on selected products such as jeans, motorcycles, and peanut butter are only pinpricks. However, they can cause considerable economic damage to individual companies and their employees in the affected U.S. states, which could lead to political reactions from politicians from these states. If U.S. tariffs also apply to cars, the EU Commission would have to identify important U.S. products accordingly.

European retaliation should be moderate in the sense that the EU should only follow suit in terms of the volume of U.S. exports concerned and impose punitive tariffs on U.S. exports equivalent to the volume of EU exports to the United States affected by U.S. punitive tariffs. However, it remains unknown whether President Trump will react to threats and pinpricks as hoped, or if he will react instead to further protectionist measures.

Outlook

The punitive tariffs currently in force in the United States affect international trade and ultimately damage the U.S. economy. Trade retaliation by the EU increases economic damage – both in the U.S. and in Europe. Nevertheless, moderate reactions are, in my view, unavoidable. Gabriel Felbermayr, Director of the ifo Center for International Economics, rightly states: Staying still is not an option. As the Germans say: Wer nicht handelt, wird behandelt – If you don't do something yourself, you become the plaything of others. (cf. Felbermayr 2018).

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