EURO AREA: ECONOMIC ACTIVITY

WHAT IF CAR TARIFFS LIE AHEAD?

Author

NADIA GHARBI, CFA
ngharbi@pictet.com

SUMMARY

- Among the key risks for our euro area outlook, the threat of US auto tariffs is of major importance.
- The US Commerce Department's investigation on national security threats posed by auto imports is due to be concluded on 17 February.
- Given the complexity of the global auto supply chain, it is very complicated to isolate the effect of a one-off increase in US tariffs on European cars.
- Using simple trade, elasticities and investment metrics, we try to gauge what could be the potential impact of auto tariffs on euro area growth.
- We find that autos tariffs would reduce our annual euro area GDP growth by at least 0.2-0.3 percentage points. Consequences on the very exposed European car industry (Germany's and some eastern European countries' in particular) would be even more significant.
- As a result, against our baseline (without higher tariffs) for 2019 euro area GDP growth of 1.4%, such a scenario would suppress our growth forecasts to close to 1.0%.
- A key question is whether the US administration will also impose tariffs on car parts and what retaliatory measures the EU would take.

Autos report is due on 17 February

In our baseline scenario, we expect euro area annual growth to slow to 1.4% in 2019, with risks tilted to the downside. Among the key risks weighing on our outlook, **the threat of US auto tariffs is of major importance**. Currently, the US charges a 2.5% tariff on imported cars versus a 10% tariff imposed by the EU. However, the US maintains a much higher (25%) tariff on pick-up trucks - a key segment for US car manufacturers - than the EU (16%).

Europe exported EUR132bn worth of cars in 2017. **The US was the main export destination of EU's cars (29% of the total or EUR38bn)**, well ahead of China (17% or EUR22bn). Among European countries, the one most exposed to the US market by far is Germany, whose car exports to the US amounted to EUR22bn in 2017.

Last year, President Donald Trump ordered his Secretary of Commerce to determine whether America's security was impaired by imports of automobiles and threatened to increase US import tariffs to up to 25%, if required. **The US Department of Commerce should release its investigation report no later than 17 February**. Once the report is released, the president has 90 days to decide what, if any, action to take.

A key question is whether the US administration will also impose tariffs on car parts. Tariffs on car parts would be a problem for US car manufacturers as their final products will also face price increases due to more expensive intermediate goods. Thus, the Trump's administration might refrain from imposing them. If excluded, that would reduce the negative impact on EU countries.

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What could be the impact of car tariffs?

Given the complexity of the global auto supply chain, it is very complicated to isolate the effect of a one-off increase in US tariffs on European cars. As an example, German companies control several US companies and could avoid tariffs by shifting production to US plants. Moreover, when trying to gauge the potential impact of protectionism **one must distinguish between the direct impact** (i.e. the impact coming from weaker demand) **and the indirect impact** (i.e. through reduced confidence). Between the two, the latter is more difficult to estimate but also the more significant factor.

Direct trade impact

To assess the potential direct effect on Europe we can use elasticities. Based on academic studies, we find that US demand for European cars declines by around 1.5-3% when prices rise by 1% (i.e. a price elasticity of demand between 1.5 and 3).

A different way of estimating the impact of tariffs is to look at the value added related to the exports of cars to the US. For this, we use the OCDE Trade in Value Added (TiVA) data[1]. The share of car exports in valued added can be interpreted as an upper bound for the fallout from weaker car exports. In the euro area, **the value added in exports of cars to the US is equal to 0.10 pp of total value added (equivalent of GDP). In Germany, this is 0.32pp,** while the other large euro area economies are less sensitive to car exports to the US.

CHART 1: SHARE IN VALUE ADDED OF EXPORTS OF CAR AND CAR PARTS TO THE US

Source: PWM - AA&MR, OCDE (2011)

Indirect trade impact

Car tariffs could also impact business and consumer confidence. Of all components of GDP, private investment is the most sensitive to uncertainty; estimating how corporate

[1] The domestic value added of car export to the US is the sum of total value added in the chain of production to export that is added domestically. Included is for example the assembly of cars, transportation of cars and the energy used in the process of transporting and producing the car. Data are from 2011, since then, exports of cars to the US from Europe have increased further. Thus, the outcome could therefore be larger than these figures predict

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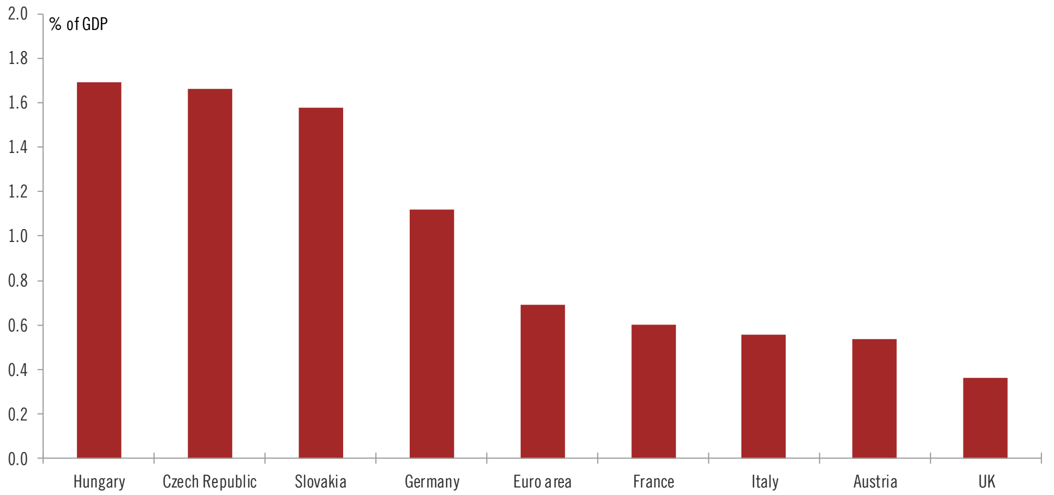
investment in the car sector will react is complicated. Total investment accounts for 20% of GDP in the euro area. There is no aggregate data on investment in the car manufacturing sector. Based on country data[2], **it accounts for 3.5% of total investment or 0.7% of euro area GDP**. At the country level, the car sector's share of investment is highest in Hungary, Czech Republic and Slovakia. Among the large euro area countries, the share is the highest in Germany (5.6% of total investment or 1.1% of German GDP) and France (2.7% of total investment or 0.6% of GDP).

CHART 2: GROSS FIXED CAPITAL FORMATION IN AUTO SECTOR



Source: PWM - AA&MR, OCDE

Combining direct and indirect impact

The magnitude of any growth impact would depend on the size of the shock to investment and trade. The underlying rules of thumb are as follows:

- (1) A 100% decline in euro area car and car part exports to the US subtract 0.1pp from euro area GDP growth (direct impact) and 0.3pp from German GDP growth;
- (2) A 100% decline in investment by car makers subtracts 0.7pp from euro area GDP growth (indirect impact) and 1.1pp from German GDP

In our base case, we assume that an increase in auto tariffs from 2.5% to 25% will cause investment in car industry to decline by 15-30%. On the trade side, we assume, given the price effect, a decline of car exports to the US by 20-30%. **This will lead to a cut of 0.2-0.3pp to our euro area annual growth forecast** (currently at 1.4%). **The impact will be more pronounced for Germany, as this could cut 0.3-0.4pp from our German annual growth forecast** (currently at 1.3%).

[2] Our estimation is based on annual data from Germany, France, Italy, Netherlands, Austria, Finland, Belgium, Slovakia, Finland, Greece and Portugal published by OCDE

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Broader implications

Importantly, beyond the direct impact on car exports and investment**, auto tariffs could also dampen private consumption via reduced employment and confidence**. According to the European Automobile Manufacturer Association (ACEA see here), the automotive sector directly and indirectly employs 13.3 million people, representing 6.1% of total EU employment. Furthermore, car tariffs will add to an already challenging backdrop for Europe and in a period of weakening business confidence.

Key conclusions

Overall, auto tariffs would have a meaningful impact on euro area growth

- The economic impact would be significantly greater than the previously imposed tariffs on steel and aluminium.
- A key question is whether the US administration will also impose tariffs on car parts.
- Based on our assumptions, we find that tariffs would markedly reduce **our 2019 growth outlook by 0.2-0.3pp at least** (currently at 1.4%). **The impact is significant for Germany in particular.**
- More importantly, for the whole economy, new tariffs will increase the risk of further escalation. Therefore, the indirect impact from the shock to confidence (affecting investment and consumption) could be much greater than the direct impact from trade.

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