



Trump, trade and the EU: Two wrongs don't make a right

by John Springford and Christian Odendahl
23 February 2017

The US will not gain by resorting to protectionism. If it does so, the EU should stay calm, listen when US criticism is justified, and make its first priority the defence of the WTO process and the rule of law.

Donald Trump has made protectionism a key plank of his programme to “make America great again”. While the policies he will pursue are unclear, the strategy is discernible. He has backed out of the Trans-Pacific Partnership (TPP), which was agreed before he took office, but not ratified; the Transatlantic Trade and Investment Partnership (TTIP) is in the deep freeze for as long as Trump is president; and he promises to renegotiate the North American Free Trade Agreement (NAFTA). Instead of multilateral agreements or large regional trade deals, Trump favours bilateral agreements, and has held preliminary talks with Theresa May about a US-UK deal. He has also threatened to raise import tariffs across the board and he has threatened specific tariffs aimed at particular plants, such as BMW’s factory in Mexico.

Trump considers trade to be a competition with winners and losers, suggesting that a trade deficit, like that of the US, is a sign of weakness. As a result, he has suggested that he will target trade policy on those countries that run surpluses with the US, to try to force them towards more balanced trade. In Europe, the country with the largest surplus with the US is Germany, which has been accused by Trump’s team of using the euro to keep its products cheap on world markets. Trump may try to label Germany a ‘currency manipulator’, alongside China. This would allow his administration first to persuade, and then use measures, to force ‘manipulators’ to change course.

Yet it is Republicans in Congress, not the White House, who have come up with a plan that could have the biggest impact on US-EU trade. House speaker Paul Ryan and Kevin Brady, the chair of the Ways and Means Committee (which oversees taxation and tariffs) [have suggested](#) a ‘border tax adjustment’ (BTA) as part of their corporate tax reform. The idea is simple: companies would no longer be taxed according to where production took place; taxes would instead be levied according to the location of sales, which would discourage multinationals from reporting profits in low-tax countries. Under this ‘destination-

based' system, revenues from exports would no longer be taxed, whereas the costs of imported goods would no longer be tax-deductible. This is not the same as an export subsidy combined with an import tariff, but the economic effect is similar. The proposal faces a good deal of domestic opposition, especially from large retailers, and Trump has complained that it is "too complicated". But it may happen, and the EU should be prepared.

Thus Trump might pose three economic problems for the EU: tariffs; action against alleged currency manipulation; and border tax adjustment.

The temptation in Europe will be to oppose Trump because of who he is, not what he does. But the EU should be cautious: a trade war with the US would be costly, and would hurt the EU more than the US. The EU's strategy should be to protect the institutions and rules that underpin global trade if Trump decides to withdraw the US from that role. Two principles should therefore underpin the EU's strategy towards the US:

- ★ Stick to the rules: use multilateral institutions to challenge US policy.
- ★ Be restrained: minimise economic costs and avoid trying to teach Trump a lesson, which could backfire.

Problem 1: Tariffs and other discriminatory measures

Trump's unpredictable nature, his protectionist instincts, and his disdain for international law and multilateralism mean that we cannot discount the possibility of US tariffs on EU imports, or the use of other measures to discriminate in favour of US exporters, such as subsidies.

If the US raises tariffs – or used other measures to restrict imports from the EU – the impact on the US economy would be small, and the losses would probably be larger than the gains. The US trade deficit would fall, but it is not particularly large, at around 2.7 per cent of GDP. Tariffs would reduce imports, but they would also tend to raise prices for consumers, as importers pass on the cost. Inflation would rise, and at least some of the positive impact on the current account balance might eventually be offset by a higher dollar. The impact on manufacturing jobs in the US would be small, because most of these jobs have been lost thanks to automation, not offshoring.

The impact on the European economy would not be enormous either. The EU-28 ran a goods trade surplus of \$135 billion with the US in 2015, up from \$97 billion in 2010, the year that the euro crisis started. Higher import tariffs would reduce European manufacturers' export earnings in the US, and would also put a dent in the eurozone's growth strategy, which until recently has been focussed on exports outside Europe. Meanwhile, austerity at home has hit demand for imports. But the EU remains a fairly closed economy, with most trade conducted between its member-states – and exports to the US are only 2 per cent of EU GDP. Lower export sales in the US would be damaging, but would not be a calamity.

While the macroeconomic effects would be limited, important exporting sectors such as machinery, cars, aircraft, chemicals and pharmaceuticals could suffer significant fall-out. Thus the EU would – and should – take a case to the World Trade Organisation (WTO) if the US unilaterally discriminated against EU imports, rather than attempting to retaliate unilaterally itself. A case at the WTO would take around a year and three months, and potentially longer if the case is complex. The US would have up to 15 months

to comply with the WTO's judgement. Only if it failed to do so could the EU retaliate, and it would have to get WTO agreement for the steps it took. By strictly following the letter of the law, the EU would only find redress two or three years later, but by acting through multilateral institutions, the EU would prevent those institutions from being further undermined by unilateralism.

Problem 2: Being labelled a currency manipulator

The Trump administration must go through several hoops, according to US law, before labelling a country a currency manipulator. The country's trade volumes with the US must be more than \$55 billion a year and it must have a trade surplus of more than \$20 billion with the US. Germany fulfils those criteria. But it does not make the ECB intervene in currency markets to lower the euro's exchange rate – and the euro's depreciation against the dollar coincided with the ECB's decision to start quantitative easing in 2015, in the teeth of German opposition.

And even if Trump labels Germany a currency manipulator, the law that underpins the process does not allow him to take action unilaterally. The administration must first enter into negotiations to try to get the country to change its exchange rate policy – negotiations which were successful when the US branded Japan, Taiwan and China manipulators in the 1980s and 1990s. The law also requires that the US use the WTO process, not unilateral action, to retaliate.

The German finance minister, Wolfgang Schäuble, has singled out the ECB's aggressive monetary policy as a cause for Germany's current account surplus. It is true that a weaker euro, which was part of the ECB's strategy to revitalise the eurozone's sluggish recovery, led to a widening of the current account of the bloc as a whole. But the underlying causes of Germany's [current account surplus are structural](#) and need to be addressed as such.

Germany should take the sensible economics behind the US's repeated warnings about its current account surplus more seriously. [Structural reforms to revive domestic investment](#), alongside macroeconomic policies to stimulate demand across the eurozone are in the EU's interest. The eurozone's large and persistent current account surplus is simply sowing the seeds of the next financial crisis by reducing interest rates globally and encouraging unsustainable investment outside Europe.

Problem 3: Border tax adjustment

There are two questions about the economic effects of the Republican BTA proposal: the effect on the dollar and whether the reform would be legal under WTO rules. The answers to those questions should determine the EU's response. The dollar probably would appreciate after the tax reform (with the usual caveats about economists' ability to forecast applied). The BTA would raise demand for US goods, and hence, US dollars on foreign exchange markets. This would make US goods more expensive abroad and foreign goods cheaper on the US market, offsetting at least some of the BTA's benefits for US exporters. Meanwhile, imported inflation might prompt the Federal Reserve to raise interest rates, making it more attractive to invest in dollar assets, which would also raise the value of the dollar.

Would the BTA be compatible with WTO rules? WTO rules allow indirect taxes (such as value added taxes) that are levied on imports, but not on exports. The reason is that VAT does not discriminate between foreign and domestically produced goods, because the tax is levied on domestic production as well as imports. (And empirical studies of the effects of value-added taxes have found no effect on trade patterns.) The WTO treats direct taxes – taxes on revenues or income, such as the BTA – differently. If revenue or income is derived from export sales, and is exempted from taxation, the WTO considers the tax exemption to be an illegal export subsidy. The distinction between direct and indirect taxation under WTO rules is a source of repeated disputes between the US and Europe, without any permanent resolution. The US thinks that value-added taxes discriminate against its exporters, and wants to use direct taxes in response, which the WTO rules forbid.

The proposed BTA could be made to mimic a value-added tax on the import side. The House Republicans' current proposals would make domestic producers' wage costs tax-deductible, but not the wage costs embedded in imports. If the labour costs of imported goods could also be tax deductible, the reform would not be discriminatory against importers.

Given that there is little immediate danger to the European economy, the EU should stay calm and be proactive. The EU should propose a new settlement on WTO tax rules. The border tax adjustment plan has some advantages, since it means corporations pay taxes according to the location of their sales, not where the company is headquartered. This could remove multinational companies' incentive to base headquarters in low tax jurisdictions. EU member-states might be unwilling to adopt a similar system themselves. But they could offer to change WTO rules to make the BTA legal, as long as the US agrees to make the wage costs of imports tax deductible, which would mean that trade was not distorted.

In short, the EU should not over-react to any protectionist measures that the Trump administration pursues. A trade war with the US would be damaging for both sides, and it would undermine the WTO. The US's concern about the eurozone's current account surplus is justified (while the view that Germany manipulates the value of the euro is wrong-headed). And while the border tax adjustment plan, if enacted, might result in discriminatory effects, it would be better for the EU to seek a solution to the dispute over VAT and corporate tax than react defensively to tax reforms after the fact. Like it or not, Europe will have to engage with the Trump administration on trade, and it should do so in the spirit of negotiation and compromise, and try to uphold multilateral international law in the face of growing unilateralism.

John Springford is director of research and Christian Odendahl is chief economist at the Centre for European Reform.