Who is affected by the trade conflict between the EU and China?

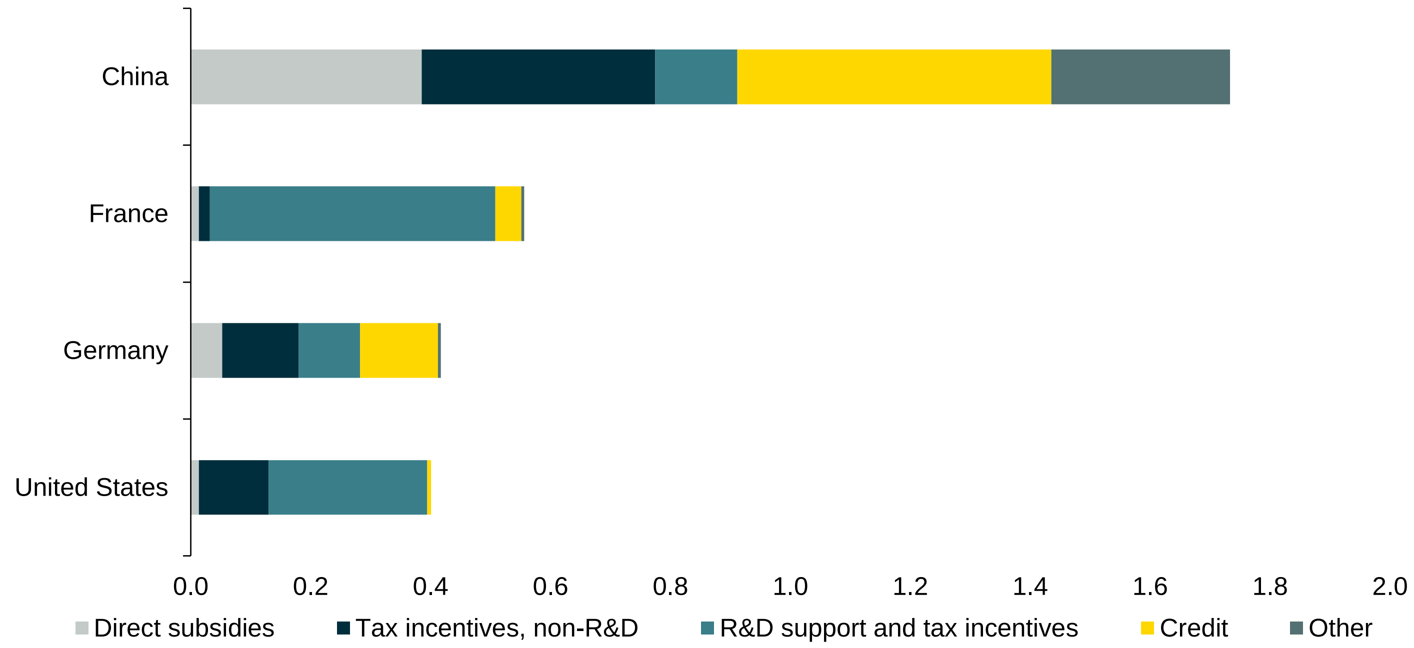
Dr. Vincent Stamer

Following recent tariff hikes by the United States, the European Union is expected to raise tariffs on several goods from China – most currently electronic vehicels (EVs). Bejing has already threatened retaliation and we believe that China will likely target a combination of cars, airplane parts and spirits. This would hit the German car industry in several ways. While the current dispute will have very limited effect on the resurging European inflation. A full-blown trade war with China and worldwide deglobalization would, however, increase inflationary pressure and dampen growth prospects.

An escalation of the conflict is imminent

Geopolitical tensions have risen between China on the one side and the United States and the European Union on the other. As a result of the tensions, calls for a more protectionist trade policy towards China have become louder – particularly in the US where the two presidential candidates want to display a tough stance on China. Proponents of trade protection typically point to the high level of industrial subsidies that help Chinese companies undercut world prices. Even before the pandemic, public institutions in China spent 1.7% of GDP on direct or indirect forms of industrial subsidies (Chart 1). This is more than four times the share that Germany or the United States spend on subsidies. A recent **study** even estimates that China may currently spend as much as nine times as much as OECD-countries. Consequently, the Biden administration levied additional tariffs on US $18 billion worth of imports from China this year, notably raising tariffs on electronic vehicles to 100%. The US has called on the European Union to follow suit.

Chart 1 - Chinese subsidies outweigh those of the West
Public subsidies by category, 2019 in % of GDP



Source: Center for Strategic & International Studies, Commerzbank-Research

The European Commission is already investigating unfair trade practises by China in several cases. Given Brussel's recently set aim toincrease its production capacity in green technologies, it is not surprising that the investigations of unfair trade practises launched against China have targeted electronic vehicles (EVs, October 2023), biodiesel (December 2023) and wind turbines (April 2024). According to media reports, the investigation into electronic vehicles is about to conclude soon. Brussels has also investigated individual Chinese companies bidding for photovoltaic park projects in the EU, but has refrained from any largescale investigations.

If the investigations do find unfair trade practises, the EU could introduce tariffs that counteract the unfair advantage of Chinese exporters.

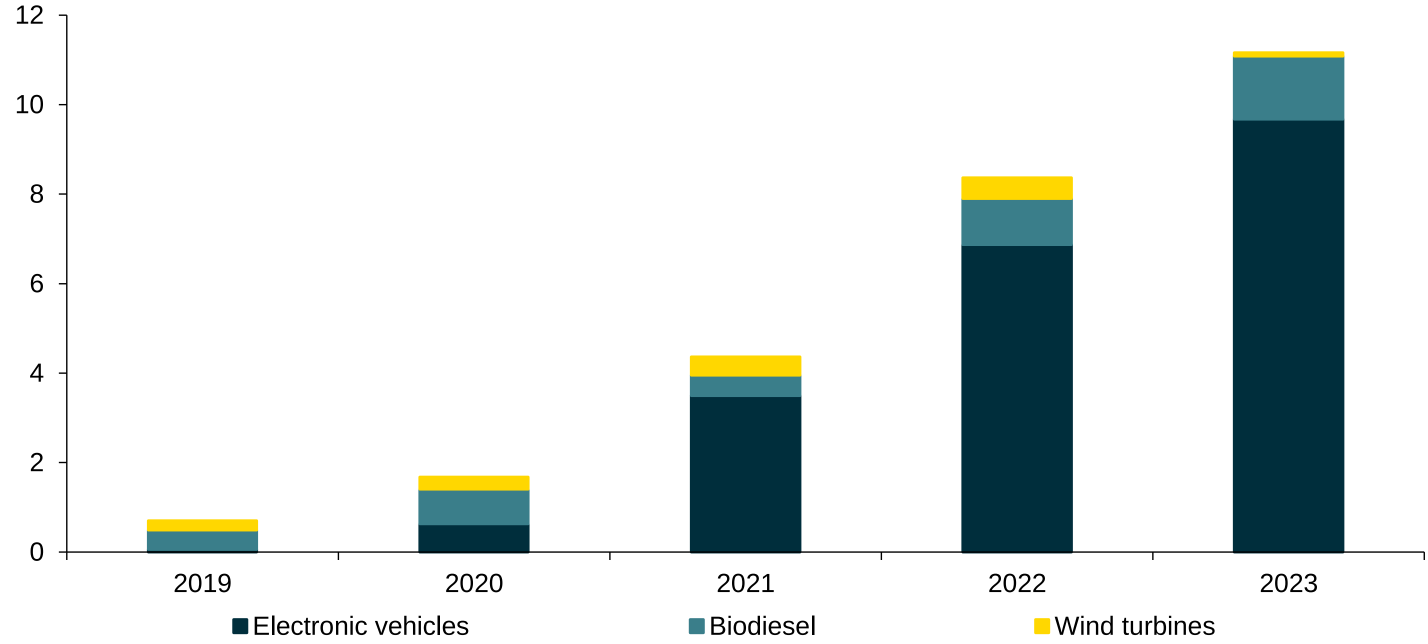
European tariffs will target skyrocketing EV imports from China

Imports of goods potentially affected by customs duties now involve large volumes: In particular, Europe's imports of EVs from China have grown strongly to almost 10 billion Euros worth of cars in the past year. This also implies for Germany, for example, that a quarter of all EV imports were from China – the single most important exporter of EVs. In terms of volumes biodiesel and wind turbines are less important, although purchasing biodiesel from China has also more than tripled within five years. The import of wind turbines reached its peak in 2022 with a volume of 460 million Euros. If the European investigators find evidence of unfair trade practises by China, the European Commission will likely raise tariffs on Chinese cars from the current level of 10% to the range of 25% to 40% (implying a punitive, "anti-dumping" tariff of 15% to 30%).

The effect of this tariff on imports mainly depends on whether Chinese exporters lower their prices in response. A **study** finds that Chinese exporters may be able to absorb additional tariffs up to 30% due to their very high profit margins. If the import price overall does increase, however, will European consumers either have to pay a higher price or switch to cars from alternative sources.

Chart 2 - European imports of clean technologies from China have risen

In Billion Euros



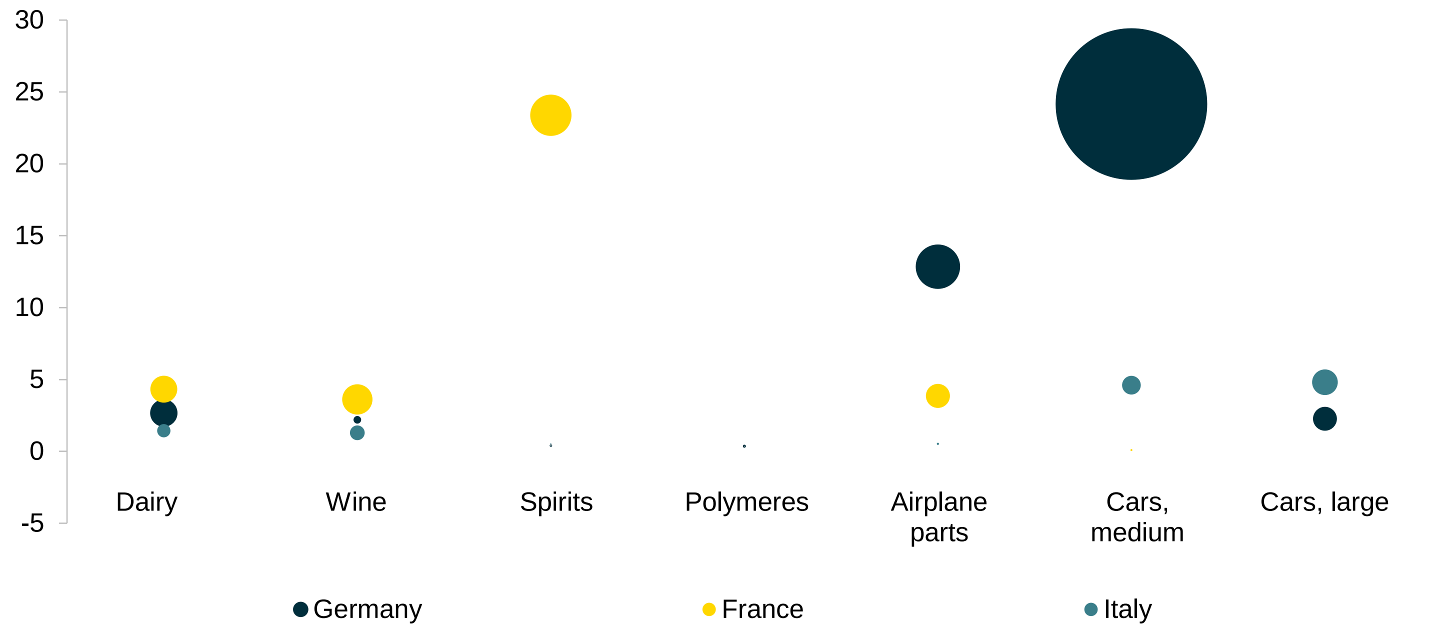
Source: Eurostat, Commerzbank-Research

How will China retaliate?

Bejing has already threatened retaliation if the EU was to levy anti-dumping tariffs. Products mentioned in this context are dairy products, wine, spirits and liquers from grapes such as brandy, specialty polymers, airplane parts, medium-sized cars and large cars. Only cars with a spark ignition engine are considered. There are several reasons why gasoline engine cars rank highest among the likely targets by China: First, the share of German car exports going to China is comparatively high with 24% (Chart 2). This makes Germany, an influential voice in Europe, vulnerable to Chinese trade policy and causes further division within Europe.

Chart 3 - Few European products depend on the Chinese market

The share of European countries' exports going to China (including other European countries) in %, the size of the bubble represents the trade volume in US dollars



Source: UN Comtrade, Commerzbank-Research

Second, China has preferred to employ punitive tariffs in the same product category as Europe in a "tit-for-tat" fashion. For instance, the announcement by China to investigate European polyoxymethylene copolymer, an industrial plastic, came just a month after Europe imposed anti-dumping levies on Chinese polyethylene terephthalate (PET) products. Third, as Europe exports 12,6 billion Euros worth of medium-sized cars with a cylinder capacity of 1,5 to 3,0 liters to China, the trade volume approximately matches that of European EV imports from China [1]. Due to China's rhetoric on using trade policy to safeguard environmental protection targets, large cars are also a likely target. Since France has pushed for a firmer trade policy stance, French brandy and other spirits may fall into Bejing's crosshair.

Germany's car industry will loose twofold

Even without retailiation by Bejing, German car makers will be hit by European tariffs. This is because German car companies produce EVs in China for the European market. Unless the EU makes an exception for European brands, they will also be target to anti-dumping tariffs. Under the assumption that Chinese car makers currently have a higher profit margin than their German counterparts, the former will be able to compensate more for the tariffs and will continue to capture larger market shares on the European market.

The second effect concerns retaliation by the Chinese: Due to the sensitivity to price changes in foreign cars, the response of Chinese customers to an increase of 20% of the price (an additional 20 percent retaliatory tariff), could diminish demand by up to 60%.[2] Alternatively, European car makers could reduce the price to offset the tariffs, but this would inevitably lower the profit margings. A conceivable middle-way between these two extreme alternatives would entail a slight price discount by German exporters and a reduction of the trade volume by 30% to 40%. The German economy would be hit in real terms: The lost exports to China may amount to 3-4% of car production in Germany. Even if some exports can be rerouted to third party countries, this will strain the German automobile industry.

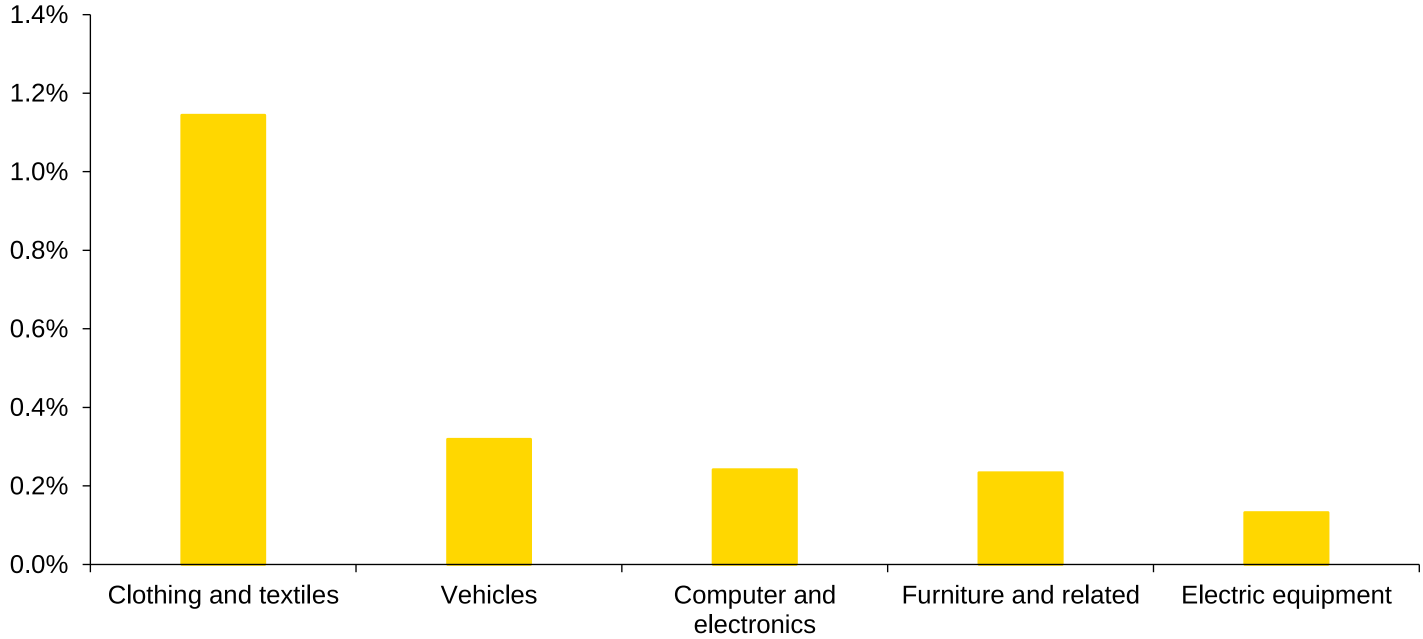
Trade disputes and deglobalization could increase inflation in the medium run

Consumer prices have recently risen again. In particular, the inflation rate without the volatile energy and food prices, has regained momentum since the start of the year.One risk is that deglobalization further increases inflation through higher prices of tradeable goods. An **ECB study** finds that given the currently modest trend of fragmentation in global trade, inflation may be 0.15 percentage points higher than otherwise. A series of trade disputes or a hard decoupling from China would significantly accelerate this process.

The effect of the current dispute on German (and European) consumer prices do depend on several factors, but will likely be limited: First of all, an imposition of an anti-dumping tariff of up to 30%, for example, does not correspond to a 30% price increase of Chinese goods in Germany. German importers may switch to suppliers from other countries and Chinese exporters may lower their prices to defend their market share. The later effect will likely come into play for EVs given the high proift margins of Chinese carmakers and their inability to expand their market share in the United States. Additionally, one should not overestimate China's value-added share of German consumption: Of 100 Euros spent by the average German consumer, only 2,7 Euros can be traced back to Chinese production. The most sizeable share of this falls onto clothing and home textiles with a share of 1.1 Euros.

Chart 4 - The Chinese value-added share of German consumption

Estimates of direct effect on consumption, %



Source: OECD, Eurostat, Commerzbank-Research

Anti-dumping tariffs of an additional 30% would translate to a 0.02 percentage point consumer price increases given further assumption. If the trade conflict does not escalate to a full-blown trade war encompassing all tradeable goods, the inflation effects of this trade dispute will therefore be limited. It nevertheless contributes to an environment of already resurging inflation.

[1] China had mentioned vehicles with an engine capacity of over 2.5 liters in its communication. According to the Chinese statistics authority, the country imported cars worth 12.4 billion Euros from the EU in 2023. Eurostat only classifies vehicles between 1.5 and 3.0 liters (called medium-sized vehicles here) and 3.0 liters or more (large vehicles). (back to text)

[2] The retaliatory duty of 20% is a hypothetical assumption. Lower and higher values are conceivable. China considers a 10% increase to be compliant with WTO law and could announce this as a first retaliatory step. (back to text)

Fed preview: When will the priorities change?

Bernd Weidensteiner

The Fed will leave the fed funds target range at 5.25% to 5.50% next week. One topic at the FOMC meeting is likely to be the recent weaker growth. For the time being, however, the Fed is more likely to see this as a desired effect of the restrictive monetary policy and as a prerequisite for successfully combating inflation.

For much of last year, things could not have gone better for the Federal Reserve: The economy grew strongly despite massive rate hikes, and inflation weakened noticeably at the same time. In recent months, however, the situation has gradually deteriorated. The decline in the inflation rate came to a halt for the time being, and measured by the deflator for consumption expenditures, it even picked up again slightly. The core inflation rate remained at 2.8%, well above the Fed's target of 2%. The annualized 6-month rate, which better reflects current price momentum, even rose from 1.9% in December to 3.2% in April. It is not yet clear whether the upward pressure on prices is strengthening again on a sustained basis or whether this is just a statistical outlier due to possible problems with seasonal adjustment. Although price pressure appeared to ease somewhat in April, a definitive answer to this question cannot yet be given.

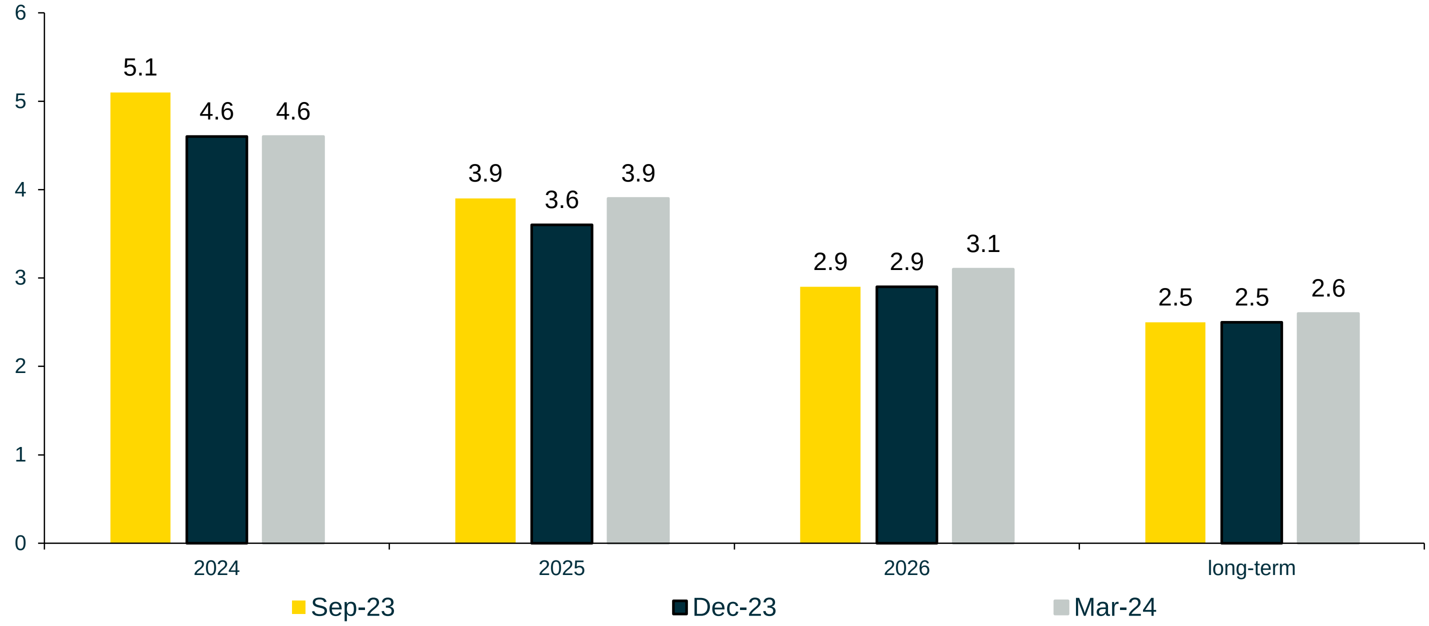
At the same time, economic growth has slowed down: the economy only grew by 1.3% in the first quarter, and the second quarter is unlikely to be much better. There are no strong signs of a possible recession in the figures. However, it is clear that the risks for the Fed are no longer as one-sided as they have been in recent quarters. However, the Fed is unlikely to react to some weaker growth figures with a rapid change in policy, especially as there have some phases of weakness in recent years. The cooling of the labor market in particular should also serve as evidence for the Fed that the restrictive policy is working as intended. After all, a prerequisite for a further decline in inflationary pressure is that excess demand on the labor market is reduced and thus wage growth continues to slow. As long as the labor market continues to create more than 100 thousand new jobs per month, the Fed will not be overly concerned about this.

The Fed is therefore likely to wait some time before lowering key interest rates. We therefore assume that it will leave the target corridor for Fed funds unchanged at 5.25% to 5.50% at next week's meeting.

The Fed will also publish the updated projections of the Fed governors and presidents next week. In March – the last update – 75 bps pf rathe cuts (i.e. three steps of 25 basis points each) were still expected for 2024. By contrast, the Fed's top officials had removed a rate cut from the projection for 2025 (Chart 1). If the Fed's risk assessment has changed, the projection for the medium term could again show somewhat stronger interest rate cuts.

Chart 1 - Dot plot - how many rate cuts?

FOMC meeting participants projections of the appropriate policy path. Mid point of fed funds target range, year-end levels.



Source: Fed, Commerzbank Research

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