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WEEKLY ECONOMIC COMMENTARY

IN THIS ISSUE:

- **A New Transatlantic Trade War Looms**
- **The Return of Steel and Aluminum Tariffs**
- **China and the U.S. Trade…Tariffs**

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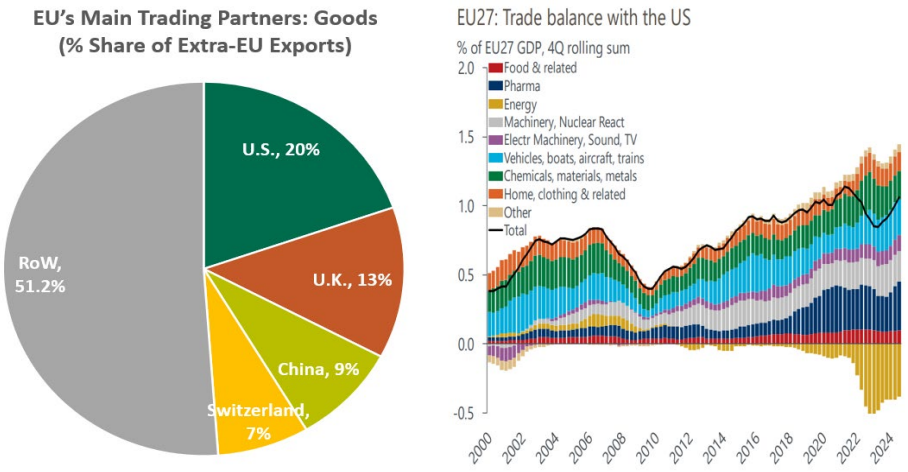
The Biblical story of David and Goliath offers inspiration to underdogs facing seemingly impossible battles. David, a shepherd, defies all expectations and defeats the giant Philistine to become king.

On today's trade battle grounds, there are unlikely to be any Davids. But observers will be watching the clash of the Goliaths in international commerce.

America's looming trade confrontation with the European Union (EU) will be one such skirmish. The two markets have the world's largest commercial relationship, with goods and services worth over $1.5 trillion changing hands each year.

In a major escalation, President Trump has announced 25% tariffs on all steel and aluminum imports that will take effect on March 12. This would not only revive an old trade dispute with the EU from his first term, but will also represent a 15 percentage point increase from the prior duty on aluminum. The President has threatened reciprocal tariffs against EU countries, levies that are equal to the tax rates that other nations charge on U.S. imports. Uncertainty around the timing and scope of the administration's protectionist measures is quite high.



Sources: Eurostat, Oxford Economics, Haver Analytics

America is the top destination for European goods, contributing to a $160 billion EU surplus in 2023. Machinery, pharmaceuticals and autos account for well over half of the bloc's shipments to the U.S.

It bears mentioning that the U.S. has a substantial ($110 billion) surplus in services trade with its partners across the Atlantic. Europe is the strongest market for America's digital services; scientific, technical, and financial services lead the list. These activities support

nearly 100,000 jobs in the United States, and might certainly be a target of EU retaliation in any trade scuffle. The net of goods and services exchanges between the U.S. and the EU is not a large number, but Washington seems fixated on merchandise flows.

EU member states vary in their direct trade exposure to the world's largest economy. Among the major ones, Germany, Italy and Ireland rely most heavily on demand from the United States. Germany is by far the bloc's largest exporter of goods to America, representing over 30% of transatlantic product shipments.

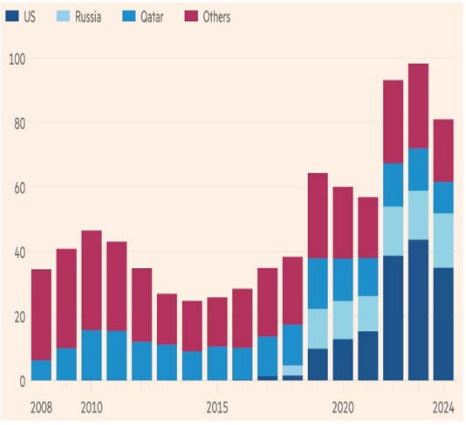
President Trump has long complained about Europe's higher import taxes. American goods face an average tariff rate of 3.95%, only slightly higher than the 3.5% levies applied to products that head west across the Atlantic. However, the imbalance is more pronounced for automobiles, food and beverages. The EU levies a 10% duty on imports of American cars, compared to U.S. tariffs of 2.5% on European cars. On food and beverages, European tariffs are on average 3.5% higher than those set by the United States.

The U.S. administration's grievances with the EU do not end with trade: North Atlantic Treaty Organization (NATO) defense spending is also a sticking point. Seven EU nations failed to hit the goal of spending 2% of gross domestic product (GDP) on security last year, with several reaching the target only after a late spending push in the run up to the U.S. election. America is also pushing for a boost to defense outlays to 5% of GDP, a goal higher than the 3.5% which the U.S. currently spends.

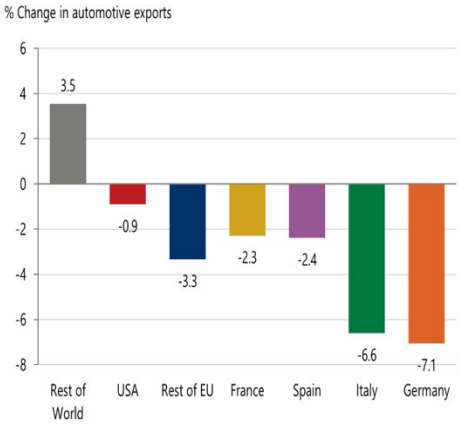
De-escalation will remain the preferred option for the EU, given the potential hit to economic activity of a full-on trade battle. There are three central options to appease the U.S.: the EU could buy more American oil and gas, it could substitute American imports for Chinese imports, and it could meet NATO spending targets by purchasing more materiel from the U.S. While certainly within the realm of the possible, all of these options could stress the delicate fiscal positions of many member states.

Europe has more retaliatory tools up its sleeves than it did in 2018.

EU LNG Imports by Country (million metric tons)



Impact of 25% Tariffs on the EU Auto Industry



Sources: FT, Kpler, Haver Analytics

The messaging from the EU is hardly conciliatory, calling for a "firm response" to America's trade policies. At the onset, Brussels' reaction is likely to closely resemble the 2018 experience, with new levies potentially covering metals, agricultural products, chemicals and jets.

In a worst-case scenario, the EU could even deploy their 2023 Anti-Coercion Instrument. The tool enables the bloc to go far beyond a tit-for-tat tariff escalation, opening the possibility of restrictions

on U.S. foreign direct investment in Europe and access to public procurement. The EU could also reintroduce the suspended digital services tax to target large tech companies.

A transatlantic trade war will be painful for both sides, but more so for Europe. The continent has fallen behind the U.S. and other major markets in economic growth and competitiveness. A 10% tariff could subtract up to 0.6 percentage points from the GDP of major economies like Germany and Italy by 2027, according to Oxford Economics.

Trump's protectionist agenda will hit the German and Italian economies especially hard.

The German and Italian vehicle industries will be the most exposed to a 25% tariff on EU auto exports: Oxford Economics estimates a 7.1% and 6.6% decline in German and Italian auto shipments in this event. The sector is an important source of employment, supporting around 14 million jobs.

Investments will take a hit amid uncertainty, higher costs, and a weaker demand backdrop. The European Central Bank will find itself caught between upward inflationary pressure from a weaker euro and a negative growth shock. Given the risk of stagflation, the central bank will likely be forced to go below the neutral policy rate.

As the U.S. and the EU sling stones at one another, we don't expect to see either side emerge a winner. The parable of Goliath teaches us that pride leads to failure, and that one should never underestimate an opponent. World markets can't afford to have either of these trade titans felled.

Heavy Metal Thunder

The Trump administration has announced new tariffs for three weekends in a row. The first round, against Colombia, was quickly reversed. The next, targeting Canada, Mexico and China, was limited only to China, with North American nations getting a reprieve. The latest move, involving metals, is likely to be permanent.

During his first administration, President Trump's trade team initiated an investigation and justified tariffs under Section 232 of the Trade Expansion Act; the Act affords the president the right to impose tariffs to protect national security. The Biden administration temporarily loosened policy in 2022, with a quota system allowing many metal imports to arrive duty-free. In exchange, the European Union revoked its retaliatory levies on U.S. products like motorcycles and whiskey. Notably, tariffs on Chinese steel were never rescinded.

Biden's détente was set to expire in March 2025, requiring renewed negotiations. The conclusions of the 2018 trade investigation remain valid, and the national security rationale is justifiable. U.S. primary production of steel peaked in 1973, and its production of aluminum peaked in 1980. Today, roughly a quarter of the steel and half of aluminum used in the U.S. are imported.

This represents a security risk. In times of conflict, sources abroad may no longer be reliable. Sudden national defense demand would quickly overwhelm the nation's capacity. And while not the primary rationale of the action, many nations do subsidize their metal manufacturing sector, putting U.S. exports at a disadvantage.

These industry-specific tariffs are meant to bring about a change in trade patterns, rebuilding productive capacity in the U.S. while limiting China's competitive prospects. Transitions of such a scale will not come quickly. A complete restoration of the heyday of U.S. metallurgy is unlikely, with the nation accounting for less than 5% of global capacity.

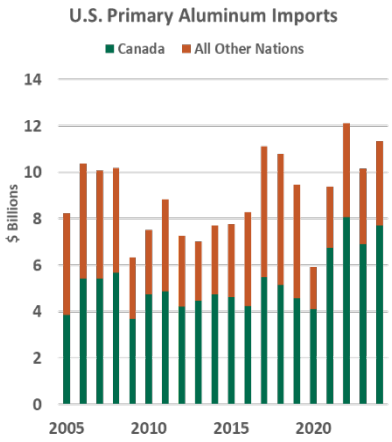
Expanding production won't be easy. American steel plants are utilizing about 80% of their capacity, and many shuttered plants are too antiquated to be brought back online. In an industry

long in decline and consolidation, appetite for new capital investment in steel foundries is limited and will run afoul of environmental regulations. Even if pollution standards were lifted, the availability and cost of energy will constrain domestic expansion. The disruption from new tariffs will be swift; the upside from supporting domestic industry will be gradual.

Production of new (*primary*) aluminum is energy-intensive, with an especially large requirement for electricity. Factories (*smelters*) are typically located near abundant sources of energy, like large rivers. Primary aluminum is made from bauxite, a mineral of which the U.S. has limited reserves and few active mines. Domestically-produced bauxite is typically used for other chemical production processes. Amid these constraints, about 80% of current U.S. aluminum production is *secondary*, recycling scraps from primary production and post-consumer waste.

Raw Steel Production by Nation, Millions of Metric Tons, 2024

China	990
India	150
Japan	85
U.S.A.	81
Russia	75
Germany	35
All others	484
Total	**1,900**



Sources: U.S. Geological Survey, Census Bureau, Haver Analytics

Tariffs on metals are unlikely to bend.

We were recently disoriented by the pronouncement and suspension of tariffs on Canada and Mexico. While those across-the-board tariffs are off the table, these nations are at risk of the metals action. Canada is the largest external source of steel, at about a quarter of U.S. imports; Mexico ranks in third place, just behind Brazil. All of these nations have only a trivial output compared to China, whose overcapacity has distorted the steel market. And Canada dominates the U.S. supply of aluminum, representing 40% of imports.

The metal tariffs are codified, with an effective date of March 12, 2025. Those hoping to see them as the next page in the escalate-to-deescalate trade playbook may be disappointed. Unlike tariffs targeting a single nation, steel and aluminum are broad categories affecting dozens of trade relationships, meant to bring about lasting change. There is no demand being made upon other nations to earn a deferral; Trump explicitly stated “no exceptions” when announcing the rule.

Stay tuned: next weekend could bring another interesting twist in the tale of the tariffs.

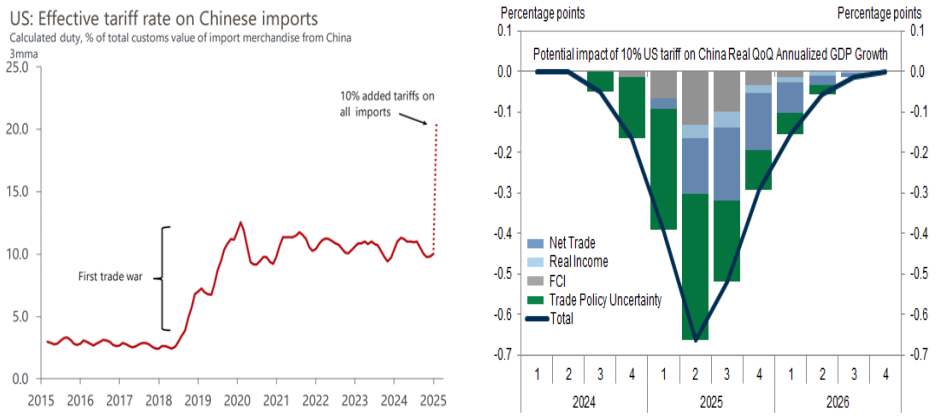
No Exception

Much of the focus last week was on tariff drama within North America. But whereas the U.S. granted its neighbors a thirty-day reprieve from new restrictions, no such accommodation was made for China. An additional 10% duty has been applied to all American imports from China, including small parcels that had been covered by a *de minimis* exception.

Beijing responded by raising its tariffs on energy imports from the U.S. and further limiting exports of critical metals used in American manufacturing of high-tech products. While not insignificant,

analysts view the response as somewhat measured; if tension escalates, China could sanction American agricultural commodities, as they did with damaging effect in 2018.

Whereas the scale of recent threats against Canada and Mexico has been somewhat unexpected, the move against Chinese products is not. China maintains a massive trade surplus with the U.S., and has long been accused of unfair practices. Negotiation has not produced much progress: in 2020, China signed an accord with the United States under which it agreed to purchase $200 billion in additional imports over the coming two years. But by the end of 2021, China had only fulfilled 58% of its commitment.



Sources: Oxford Economics, GS

China and the U.S. land initial blows in what could be an extended trade battle.

If sustained, Oxford Economics estimates that the 10% tariff top-up against China will add 0.2% to the rate of inflation in the United States. The impact on China could be more significant: Goldman Sachs estimates a decline of up to 0.7% in the pace of real growth, an unwelcome result for an economy that is already dealing with substantial headwinds.

At this juncture, escalation may be more likely than diffusion. President Trump has said that last week's tariffs are an "opening salvo." China has filed a grievance with the World Trade Organization, but that body is not in a position to produce binding verdicts.

There is no outline for a comprehensive agreement between Washington and Beijing. And because the relationship between the two has both strategic and commercial elements, negotiations along this axis carry a very high degree of difficulty. The world and its markets may have to get used to a tense relationship between its two biggest economies.

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