The U.S. Shift to Protectionism and the Euro Area Economy

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Introduction

[SLIDE 1] I thank you for the opportunity to participate in this preparatory meeting.

[SLIDE 2] I thank Veronica for providing me with an advance copy of her paper, "Euro Area Risks Amid U.S. Protectionism" (Bottazzi, et al., 2025). Veronica and her co-authors have provided us with a very well-written paper that discusses the mechanisms through which higher U.S. tariffs will affect the Euro area economy and some estimates of the impact. The paper then provides some policy recommendations. The conclusion is that the impact could be manageable provided that the policy reaction is appropriate. In particular, policymakers should avoid the temptation to impose reciprocal tariffs and tech industry protections, should allow the euro to depreciate, and should use monetary policy to cushion the negative impact on growth.

I would add to these conclusions. It is important to recognize that estimates of the impact of U.S. trade policy are necessarily imprecise, partly because the tariff policy of the U.S. is very uncertain. That uncertainty means it behooves Euro area policymakers to look at various possible scenarios in terms of the magnitude, timing, and breadth of the tariffs and to be nimble and willing to adjust policy as the U.S. policy is implemented. Given the nature of how the Trump administration is implementing policy, uncertainty is not going to be resolved soon. And the uncertainty itself will affect economies before the tariffs are necessarily implemented. So, policymakers need to be willing to act sooner rather than later to ensure that policy is well positioned and respond appropriately once more is known about the actual tariff policy being undertaken.

[SLIDE 3] It is clear that the new U.S. trade policy is a step back from the trend in recent decades in which global trade has become more open.

[SLIDE 4] However, since the global financial crisis, protectionism appears to be rising in several countries.

[SLIDE 5] Based on both theory and evidence, this reduction in trade openness will have a negative effect on macroeconomies over the longer run. (See Chari, Henry, and Reyes, 2021, and Audzei and Brůha, 2021). But the calls for protectionism in the U.S. partly reflect the fact that as an economy transitions to more liberalized trade, not everyone benefits. Failure to address the costs to certain sectors and regions has led to skepticism of the well-established benefits of open trade.

[SLIDE 6] Indeed, the Trump administration has stated several goals for increased tariffs, including protection of U.S. manufacturing jobs, reshoring of manufacturing into the U.S., raising government revenues, and reducing bilateral trade imbalances.

Of course, some of these goals are not mutually consistent. For example, if the tariffs result in reduced imports and manufacturing moving back into the U.S., then tariffs will not result in increased revenues. Moreover, raising tariffs will not solve the fundamental factor driving the U.S. trade deficit, namely, the fact that Americans consume more than they save.

[SLIDE 7] Higher tariffs have differential impacts on the country imposing the tariffs and their trading partners. And the precise effects depend on the details of the goods on which the tariffs are imposed. To the extent that importers can shift their supply chains to avoid the tariff or can use substitute products, the higher tariff will have less impact. Similar, currency adjustments can cushion the impact. That said, typically consumers in the country imposing the tariffs will experience higher prices and inflation measures will temporarily rise until the higher prices work through the economy. Economic growth tends to fall.

[SLIDE 8] An additional impact comes from the uncertainty around the policy. To the extent that it isn't clear what goods will be tariffed, or what the level and duration of the tariffs will be, business and

consumer sentiment can decline, businesses can be reluctant to make longer-term investment or hiring decisions and consumers can be reluctant to spend. So, uncertainty can have a separate, negative effect on economic growth and employment.

We saw this during the first Trump administration. While there were concerns that inflation would rise with the higher tariffs imposed in 2018 and 2019, inflation didn't rise and the effect was seen in lower investment and manufacturing hiring, which ultimately led the Fed to lower interest rates in response. (See Flaeen and Pierce, 2019, and Furceri, Hannan, Ostry, and Rose, 2019.)

[SLIDE 9] Trading partners of the country imposing the tariffs will experience lower exports, lower growth and employment, and a temporary decrease in inflation measures as producers of exports tend to lower prices to maintain demand for their products, but also more lasting disinflation as growth pulls back. Depreciation of the currency can help mitigate these effects, but uncertainty can also dampen activity.

[SLIDE 10] Veronica and her co-authors present some estimates based on both macroeconomic and microeconomic analysis of the likely effects of the Trump tariffs on the Euro area economy. (See Bottazzi, et al., 2025.) To get these types of estimates, certain assumptions have to be made in terms of the elasticity of demand for the goods being tariffed and the relative magnitudes of the increase in tariffs on the Euro area vs. other major trading partners such as China. They find that GDP is lower by about three-tenths to five-tenths of GDP. These estimates are lower than others have found, but the direction is similar and therefore the policy prescriptions are similar. (See ANB AMRO, 2024, and Schumacher, and Dezeure, SUERF, 2024)

[SLIDE 11] I think an important thing to remember though is that there are wide confidence bands around these types of estimates. There are several reasons that such analysis is complicated and depends

on a number of assumptions. For example, because of trade linkages, even if there is no change in tariffs on the Euro area, higher tariffs on China can affect the Euro area economy as supply chains shift. It is also important to note that trade exposures differ across Euro area countries, so the effects will differ across countries. Another consideration is the high share of goods trade that are intermediate goods. About 40-60 percent of Euro area imports from the U.S. are intermediate goods, so changes in the prices of these goods affect a wide group of industries in the Euro zone and so the effects of an increase in tariffs are larger. Another consideration is that a large share of traded goods is invoiced in the U.S. dollar. This means that a depreciation in the euro relative to the dollar, which is the natural adjustment when tariffs rise, will have less of a mitigating effect.

[SLIDE 12] Finally, it is important to remember that dynamics are going to be very important when thinking about the effects of higher tariffs and the appropriate policy responses. The short-run impacts are not going to be the same as long-run impacts. (See Audzei and Brůha, 2022.) For example, Veronica and co-authors point out the long-run negative impact of restricting U.S. technology imports into the Euro area as a response to higher U.S. tariffs. While this might protect the Euro area tech industry in the short run, it would be detrimental to Euro area productivity and, therefore, economic growth in the longer run.

Dynamics also affect how monetary policy should respond. How well inflation expectations are anchored will influence the appropriate monetary policy response. In the U.S. there are nascent signs that inflation expectations are not well anchored, so the Fed will be more reluctant to lower rates in anticipation of the slower growth due to higher tariffs. Once inflation expectations are re-anchored, the Fed might have to lower rates more aggressively.

Given the uncertainties, policymakers in both the Euro area and in the U.S. will need to do what they can to keep their policy well calibrated to where their economies are and then be very nimble and be willing to change policy if the economy evolves differently than anticipated. For example, the fiscal policy

actions being planned in Germany are another factor that will affect the Euro area economic outlook and will be an offset to negative impacts of higher tariffs. This should be calculated into any monetary policy response.

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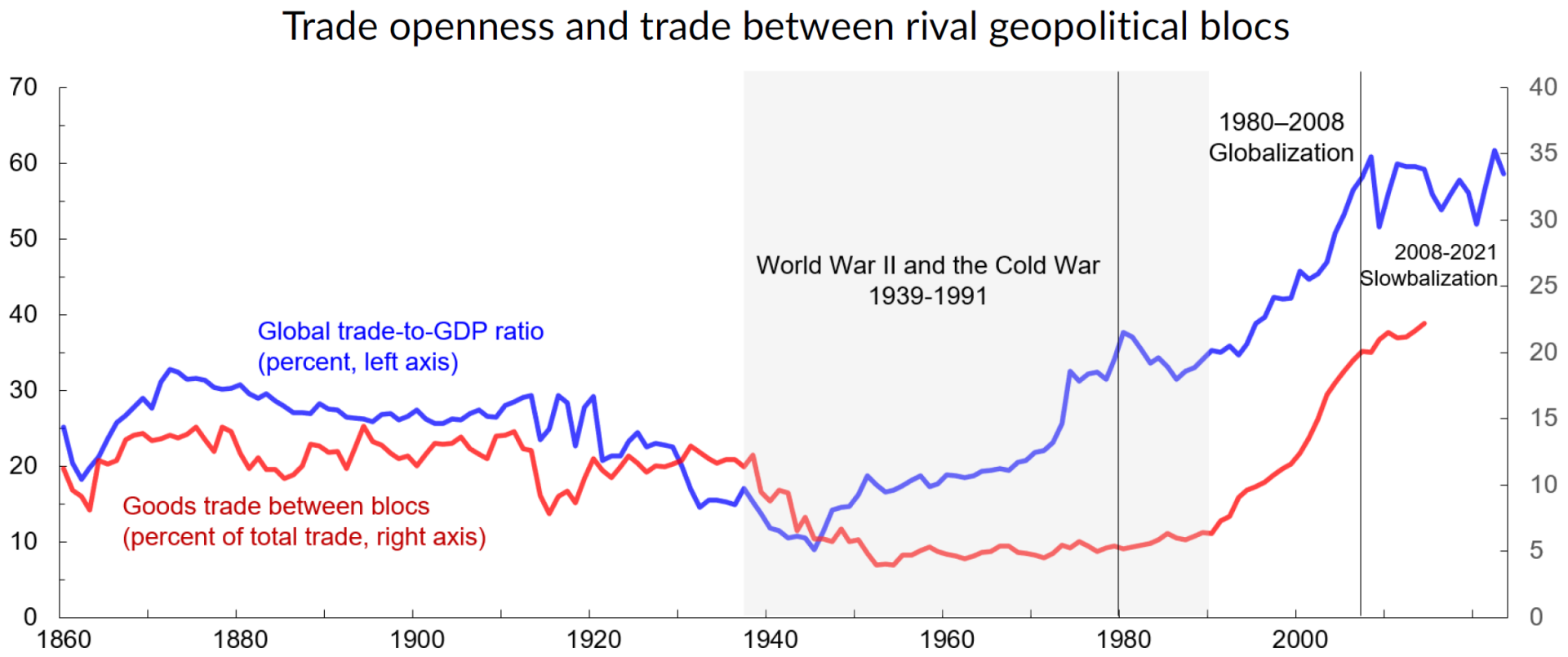
Guerrieri, et al. “Euro Area Risks Amid U.S. Protectionism”

- Very well-written paper that discusses the ways in which higher U.S. tariffs will affect the European economy and presents empirical estimates of these effects
  - 4 types of effects: direct effect of higher tariff, exchange rate adjustment btw euro and U.S. dollar, trade diversion from China, exchange rate adjustment btw euro and Chinese yuan
  - 10% tariff imposed by U.S. => 0.3 - 0.5% point lower GDP in Euro area
- Higher long-term U.S. Treasury rates may affect Euro area economy more than would higher tariffs
- Estimated effects from tariffs are relatively small provided policy reacts appropriately
  - Allow euro to depreciate
  - Ease monetary policy to mitigate impact on growth and employment
  - Resist imposing reciprocal tariffs, which would raise inflation
  - Resist trying to protect Euro area technology sector by restricting tech imports, which would hurt productivity and medium- to long-term growth

Since the 1980s, trade has become more open and trade liberalization has coincided with increased standards of living



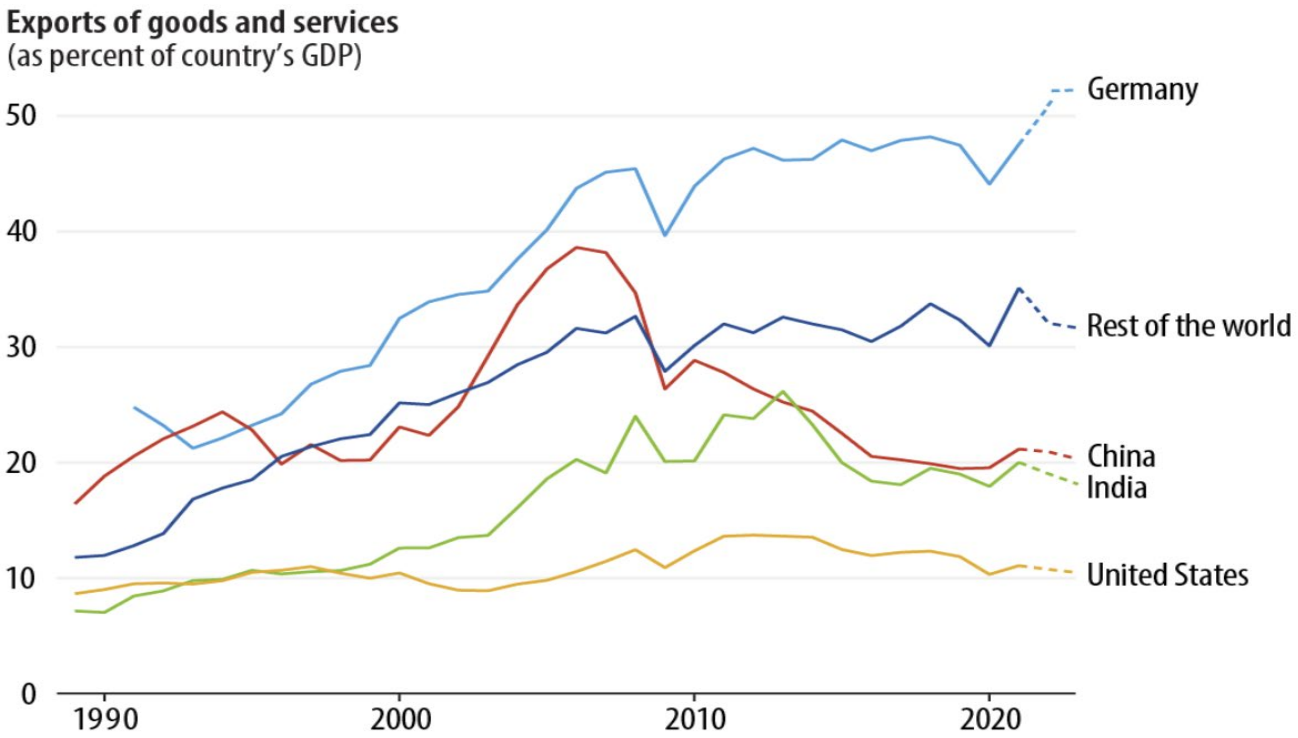
Sources: Fouquin & Hugot (2016); CEPII; Gokmen (2017); Jordà, Schularick & Taylor Macrohistory Database; IMF World Economic Outlook Database.
Note: Rival geopolitical blocs during the Cold War are defined based on Gokmen (2017).

Source: Presentation by Pierre-Olivier Gourinchas at "The Macroeconomic Effects of Geopolitical Uncertainty," 27th Annual CNB Research Conference, Nov 21-22, 2024, and G. Gopinath, P.-O. Gourinchas, A.F. Presbitero, and P. Topalova, "Changing Global Linkages: A New Cold War?" IMF Working Paper WP/24/76, Apr 2024.

Protectionism may be rising in some countries

Diverse trade experiences

Trade as a share of GDP is falling in a number of major economies, especially China and India.



Source: Goldberg and Reed (2023a).

Source: P. K. Goldberg and T. Reed, "Growing Threats to Global Trade," Finance and Development Magazine, IMF, June 2023

Research and experience: benefits of international trade but transition costs

- **Benefits of trade:**
  - More efficient production across countries via comparative advantage: specialization, scale economies
  - Increases competition => innovation and better industry performance over the long-run; higher productivity since less productive firms exit
  - Increases the variety of goods available for consumers and producers => higher welfare
    - Empirical evidence: Developing economies grew faster after trade liberalization (Chari, Henry, and Reyes, *Jrl of Econ Perspectives*, Summer 2021)
    - Theoretical evidence: No country benefits from imposing tariffs in the long run; a country loses less if it does not impose retaliatory tariffs (Audzei and Brůha, Economic Modeling, 2022)
- **But not everyone in a country benefits as trade liberalizes**
  - When production gets reallocated to a trading partner, workers need to retrain for other jobs
  - Effects on regions can be significant: rust-belt in the U.S. mid-west; furniture-making industry in the U.S. south

The Trump administration has stated several goals for increased tariffs

- To protect U.S. manufacturing jobs by raising the cost of imports and giving companies an incentive to move production to the U.S.
- To raise revenue for the U.S. government to improve the federal budget situation
- To reduce bilateral trade imbalances
- To ensure other countries compensate the U.S. for the security the U.S. offers
- To curtail fentanyl and illegal immigration

- **These goals are not mutually consistent**
  - E.g.: If tariffs successfully inspire firms relocate production to the U.S., imports ↓ and tariff revenues ↓
  - 2018 tariffs hurt U.S. manufacturing: input costs ↑; retaliatory tariffs offset positive effect of import protection (Flaaen and Pierce, FEDS WP 2019-86)
- **U.S. runs a trade deficit because it consumes more than it saves**
  - Higher tariffs won't affect the trade balance unless they change saving and investment
  - Trade deficit => financial account surplus

Higher tariffs have direct and indirect effects on the economies of trading partners

- **For the country imposing the higher tariff (U.S.):**
  - Cost of the country's imports ↑ (a tax on imports)
    - **Importers** pay the higher tariff
  - How much the price of a tariffed good adjusts depends on:
    - how easily importers can shift their supply chain to avoid the tariff,
    - how elastic the demand is for the tariffed product
    - how much currencies adjust
  - Typically, price for consumers ↑ =>
    - Temporary increase in inflation measures as the price rise works through the economy
      - Inflation might be more persistent with reciprocal tariffs or successive rounds of increases
      - Expectations of inflation could rise unless the central bank tightens policy to re-anchor expectations
  - Demand shifts from imports to domestically produced goods; typically, GDP ↓
    - Lower substitutability, tariffs on intermediate goods, or retaliatory tariff => growth lower

Higher tariffs have direct and indirect effects on the economies of trading partners, continued

- **For the country imposing the higher tariff (U.S.):**
  - Uncertainty about trade policy (e.g., on-again off-again tariff increases) can have a separate, negative effect on growth by dampening confidence and investment spending (bond premia rise and equity prices fall)
  - Empirical results of tariff increase in 151 countries over 1963-2014 (Furceri, Hannan, Ostry, and Rose, IMF WP/19/9):
    - Tariffs ↑ => output ↓, productivity ↓, unemployment ↑, inequality ↑, no Δ in trade balance, appreciation in real exchange rate over 5-year horizon
  - 2018 tariff increase hurt U.S. manufacturing (Flaaen and Pierce, FEDS WP 2019-86)
    - Input costs ↑ and retaliatory tariffs offset positive effect of import protection (Flaaen and Pierce, FEDS WP 2019-86)
    - Inflation didn't rise; Fed responded to slower economy by cutting the policy interest rate in July, September, and October 2019

Higher tariffs have direct and indirect effects on the economies of trading partners, continued

- **In trading partner of country imposing higher tariff (Euro area):**
  - Exports ↓
  - Growth ↓ and employment ↓
  - Temporary decrease in inflation via direct effect and more lasting decrease in inflation via lower growth
  - Depreciation of currency mitigates the effects

Estimates of the effects of higher U.S. tariffs on the Euro area economy

- Estimated effects of higher U.S. tariffs on the Euro area economy depend on:
  - Magnitude and duration of the tariff increase on Euro area and other major trading partners
  - Response of Euro area: exchange rate, retaliatory tariffs
  - Tariff increase on Euro area vs. other U.S. trading partners, in particular, China
  - Elasticity of demand of tariffed good
- Some estimates are larger than those presented in Guerrieri, et. al but policy prescriptions similar
  - ABN-AMRO (Aug 2024): 10% universal tariff =>
    - Cut EU exports by 1/3; reduce Euro area growth by 1.5 percentage points over 3-year horizon; lower inflation by 0.2 percentage point on average over 3-year horizon
    - Monetary policy in U.S. and Euro area would diverge
      - Growth effects dominate in Euro area and inflation effects dominate in U.S.
      - ECB responds to effects of higher tariffs by loosening monetary policy
      - Fed responds to effects of higher tariffs by tightening policy
      - Moves in value of currency mitigate some of the effects
  - Schumacher and Dezeure, SUERF (Jul 2024): 10% tariff => reduce GDP by about 0.5% over a year

Analysis is complicated because effects depend on a number of factors

- Relative size of U.S. tariffs on Euro area and China, and importance of trade among the countries
  - Change in U.S. tariff on China can affect Euro area even if no change in U.S. tariff on Euro area
- Trade exposure to U.S. differs among Euro area countries
- Supply chains now more complicated: indirect trade linkages across countries
- Response of other countries: prices of goods (elasticity of demand of tariffed good), value of currency, interest rates, reciprocal tariffs
- Share of intermediate goods vs. final goods traded between countries: 40-60% of Euro area imports from U.S. are intermediate goods so large effects
- **Large share of trade is invoiced in U.S. dollars** => depreciation of euro against U.S. dollar has less effect => less effect on inflation
- **Uncertainty and sentiment effects**: negative for growth but difficult to measure

Considerations for policy response

- **Dynamics matter a lot:** short-run, medium-run, and long-run effects can differ
  - Producers anticipate tariffs: Inflation ↑ and imports ↓ in country imposing tariffs and exports ↓ in their trading partners both when tariffs announced and again when tariffs implemented (Audzei and Brůha, 2022)
  - Direct effect of tariffs on inflation is temporary, but indirect effect through growth can be longer lasting
  - Stability of inflation expectations matters for how monetary policy should respond
  - In short-run, protectionism might help an industry, but in the longer run it can harm it
  - Deterring imports of technology can harm productivity in the medium to longer run
  - Reduced internal barriers to trade within the Euro area can help to offset negative effects of tariffs
  - Uncertainty effects can change over time
  - Theoretical modeling => even though retaliatory tariffs hurt the country imposing them, the **threat of retaliation** can help deter the initiation of a trade war (Audzei and Brůha, 2022)
- **Policymakers need to be nimble:** Keep policy well-calibrated to where economy is and where it might be going; fiscal policy (increased defense and infrastructure spending) allows monetary policy to focus more on inflation than otherwise

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