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#Europe / #Industrial Policy / #Monetary Policy

Trump's win could prompt more aggressive ECB easing

If implemented in full, Trump's tariff policies would weigh meaningfully on European growth. Even partial or temporary implementation would represent a drag, which would not be fully offset by any associated increase in defence spending. As such, we expect the ECB to ease policy slightly more rapidly.

Key Takeaways

- If a blanket 10% tariff is applied to US imports of European goods, we think the hit to Eurozone GDP could be between 0.3% and 1.0%. This is meaningful, even though this is below the forecasts of many international organisations, which overestimate the Eurozone's loss of competitiveness.
- In the more likely scenario of targeted and temporary trade spats between Europe and the US, the hit to Eurozone GDP may be between 0.1% and 0.4%.
- The inflation impact is more ambiguous. A weaker euro and trade uncertainty would push up on inflation, while weaker activity would push down on it. The -0.2% to +0.6% range we have for inflation includes both disinflation and inflation, but is skewed higher.
- Countries such as Germany, Belgium, and the Netherlands would be worst hit, given their trade intensity and exposure to the US.
- However, some European countries may significantly increase their defence expenditure in response to Trump's return to office, which could partially offset some of the negative drag from tariffs.
- Indeed, German Chancellor Olaf Scholz' decision to sack his finance minister – thereby dissolving his governing coalition – was partially motivated by considerations around looser fiscal policy.
- On balance, we think the ECB is likely to pursue somewhat more aggressive easing than it otherwise would have done. We now expect the ECB's consecutive cutting cycle to extend to April.

The market thinks Trump means weaker European growth and more policy easing

The constellation of European market moves since the US election result became clear suggests investors are pricing in a negative impulse to European activity met by offsetting fiscal and monetary easing.

For example, while US equities rose 3% in response to Trump's victory, European risk assets lagged (see Figure 1), with major European stock indices largely flat. The positive risk sentiment around stronger nominal growth and earnings boosting US assets is not being reflected in European indices.

Meanwhile, the euro has depreciated around 1.2% against the dollar at the time of writing. Euro weakness is not just a reflection of outright dollar strength, but also euro underperformance compared to other currencies. This is a sign that markets expect the European Central Bank (ECB) to react more dovishly to Donald Trump's election than other major central banks.

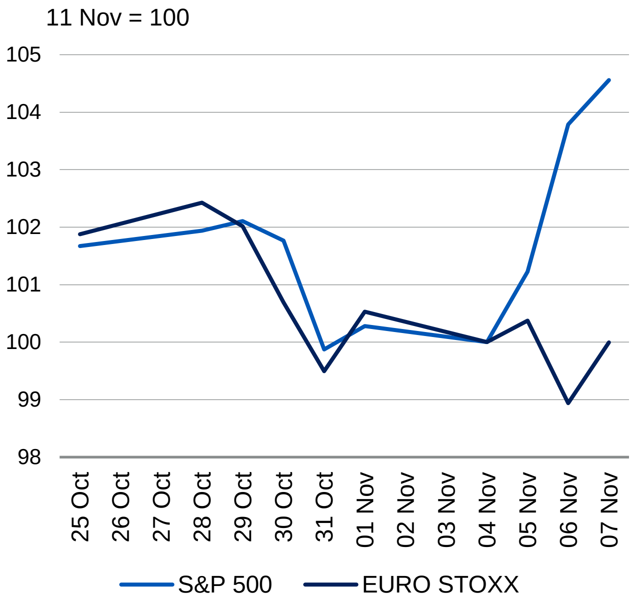
Core rates markets and peripheral spreads are largely back at pre-election levels, in line with the initial retracement of the Treasury market sell-off, although US yields have moved higher since. But the 2-year/30-year curve steepened notably, potentially reflecting the market pricing in a greater term premia on European debt in anticipation of higher future issuance.

Trump's trade policy will be a drag on GDP

Trump has proposed a universal tariff of 10%-20% on all imports to the United States, in addition to much higher tariffs on Chinese goods.

If this policy is implemented, it would have a substantial negative impact on Eurozone growth, as the US is the largest single international consumer of EU exports.

Figure 1: European equity markets underperformed the US following the election



Source: abrdn, Haver, November 2024

Several recent reports suggest that the cost to European economies of these tariffs could be substantial. For example, research presented at the recent ECB Forum claimed they would lead to a 1% fall in Eurozone GDP. The German Economic Institute suggested the tariffs would reduce German GDP by 1.2%-1.4% by 2028. And a Financial Times report suggested that EU officials thought the tariffs would reduce EU exports to the US by €150bn, which is nearly 1% of GDP.

Our own estimates are a bit smaller, at 0.3-0.9% in the case of a 10% tariff.

This is partly because, in the event of a *universal* tariff, the Eurozone's loss of competitiveness would be smaller than if the tariff was specifically targeted on European exports. US importers would not be able to switch to countries which are exempt from tariffs. And estimates of the elasticity of demand for European exports take no account of the potential for the dollar to appreciate further, partly offsetting the impact of the tariff.

The EU would almost certainly respond with retaliatory measures against the US in this scenario, exacerbating the growth shock while pushing up on inflation.

However, we do not think the implementation of a significant universal tariff against the EU is a reasonable base case. Instead, in our Trump 2.0 base case, our working assumption is that Europe is involved in isolated and temporary trade spats with the US, rather than facing the kind of systematic increase in trade restrictions under our "Trump unleashed" scenario.

Nonetheless, this process of threatening rhetoric on trade, lengthy investigations, and some measures being imposed, is likely to cause significant uncertainty for firms and financial markets, which is likely to weigh on GDP. We estimate this will cause a drag of between 0.1%-0.4% on the level of GDP spread between 2025-2027.

Moreover, even in our base case, tariffs on Chinese exports targeted in Trump's first term increase to 60%. This would hit Chinese growth, which is a major trade partner for several European countries. And there will be an incentive for Chinese producers to turn to European markets as a source of final demand for goods they struggle to sell in the US. This could lead to more pressure in Europe for trade restrictions on exports from China.

The inflationary impact is more ambiguous, and the plausible range of potential impacts includes the possibility of both a disinflationary and an inflationary shock, albeit skewed towards inflation on net.

A sustained fall in the euro partly as result of higher US tariffs will push up on the price of imported goods. And trade uncertainty could act as a negative supply shock that pushes up on prices.

However, slower economic growth both in the Eurozone and globally would push down on inflation, while demand-constrained Chinese exporters could cut prices in the European market to gain market share. Taken together, we expect a levels impact to consumer prices between -0.2% and +0.6%.

Trade uncertainty will weigh on certain European countries disproportionately

All this points to the likely divergent effects of these trade measures across the Eurozone.

For example, with the auto industry at the centre of the competitive industrial policy efforts of the US and China, Germany will continue to suffer. And French luxury goods producers, which are reliant on Chinese demand, would probably be hit if Chinese growth is much weaker.

By contrast, services-centric economies such as Spain and Portugal, which are already among the fastest growing in Europe, are more insulated (see Figure 2).

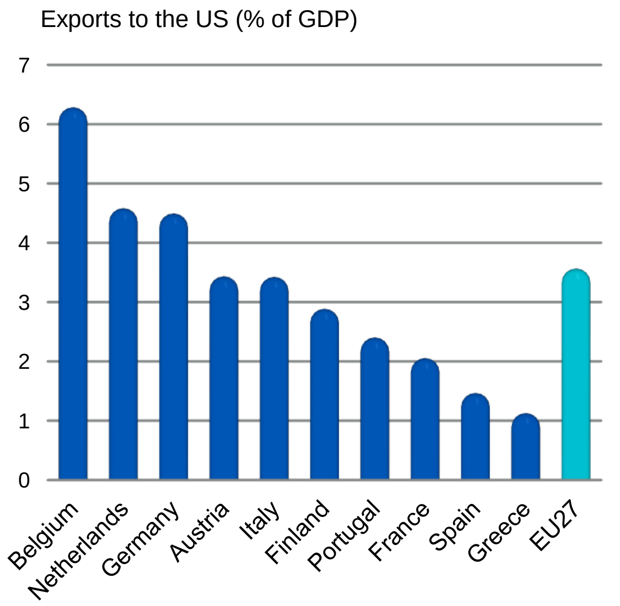
Europe on the defensive

Another key concern for European policymakers following Trump's victory will be defence policy.

Trump has insisted that all NATO countries meet the 2% of GDP defence spending required by the NATO Defence Investment Pledge. Several EU countries do not meet this condition, while Germany only meets it via somewhat creative accounting.

Meanwhile, Trump has threatened to stop US military aid to Ukraine. In our base case we expect US funding for Ukraine to become dependent on its willingness to enter negotiations with Russia. Should European policymakers wish to avoid a de facto partition of Ukraine, they would have to significantly increase military aid.

Figure 2: Trade-intensive economies will face a bigger headwind from trade disruptions



Source: abrdn, Haver, November 2024

Either way, there is likely to be material upward pressure on European defence spending and this dynamic already seems to be having an impact on politics.

German Chancellor Olaf Scholz cited the need to trigger the escape clause of the German debt brake to increase spending on Ukraine in his decision to sack his finance minister Christian Lindner. This move precipitated the collapse of the German government and new federal elections early next year.

Pressures on German spending, including, but not limited to, those on defence, render the 0.35% of GDP limit on the structural deficit untenable over the long term. So even the CDU/CSU, which is likely to be the largest party in the next government and has traditionally been committed to fiscal restraint, is likely to agree to some easing of the debt brake.

More broadly, increased spending on defence and other areas is likely to become a theme across Europe. We think these pressures will eventually result in the relaxation of the EU's fiscal rules, though this might play out over the medium term.

The increase in defence spending may help to provide a short-term growth boost that offsets some of the impact of the 0.1%-0.4% drag from trade disruptions.

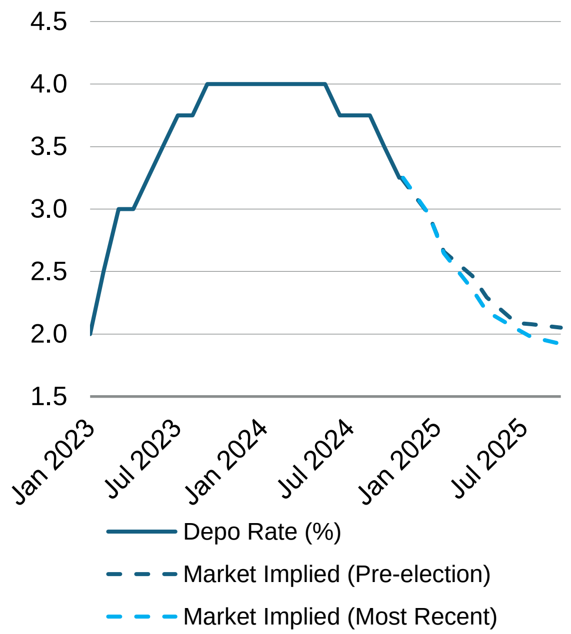
However, the demand boost from defence spending makes for a poor growth substitute for the supply hit from tariff increases. Because the European economy is close to full-employment, higher defence spending means reallocating resources towards the defence sector rather than boosting medium-term growth. Meanwhile, weaker trade flows will tend to push down on potential growth through weaker competition and less efficient resource allocation.

Marginally more aggressive ECB easing

These various cross-currents present a challenging environment for the ECB. All else equal, the hit to growth and sentiment from trade uncertainty, and softer Chinese demand would push down on rates while higher inflation from any retaliatory trade measures, higher defence spending, and a weaker euro would push up.

On net, markets have moved to price in slightly more aggressive easing (see Figure 3). We agree that this is the most likely policy response, as even if trade dynamics do push up on inflation, the ECB is likely to look through this one-off price level shock and focus on growth effects.

Figure 3: Markets expect slightly more aggressive ECB easing following US elections



Source: abrdn, Bloomberg, Haver (November 2024)

While the Fed is likely to regard many of the changes in US financial conditions resulting from a change in policy as largely endogenous, reflecting shifting expectations about the US economy, for the ECB these represent exogenous shocks.

So, if longer-maturity US interest rates were to end up materially higher as result of US fiscal policy, and this had the effect of dragging European rates higher, then the ECB might push back against this tightening by lowering the policy rate and so trying to keep financial conditions at the same degree of restrictiveness overall.

The euro has fallen 1.2% against a trade-weighted basket of currencies since last Monday, but will probably not change the ECB's reaction function, as it is endogenous to expectations for weaker growth and ECB cutting, rather than an exogenous shock that needs to be resisted. However, if dollar appreciation causes such a large fall in the euro that increased import costs push up on inflation materially, then it may need to set policy tighter.

Usually, a 1% depreciation in the euro is associated with a 4bps rise in headline inflation. Clearly, this is small, so the kind of euro depreciation that would be required for this dynamic to develop is some distance from here. However, given the potential for other inflationary shocks from trade policy and somewhat weakly anchored inflation expectations, a marked further deprecation in the euro could have a greater than usual impact on inflation.

Overall, we expect the ECB to move rates back into a neutral range promptly, probably through a series of 25bps cuts, although a 50bps reduction is not entirely impossible if the data are weaker than expected.

And we think the deposit rate will be cut beyond 2.5% without pausing, rather than pausing to assess whether 2.5% is neutral, as we had previously thought.

Under this new base case, the deposit rate hits the expected terminal rate of 2% in September 2025, three months earlier than we had previously anticipated.

Should the impact of trade uncertainty on Eurozone growth be larger than the one we have outlined above, we believe the ECB would react by moving rates below 2% next year.

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