Implications of Higher Tariffs for Euro Area and US Monetary Policy

By Jan Hatzius[1]

1 Introduction

Thank you to the ECB for inviting me to speak at the ECB Forum on Central Banking.

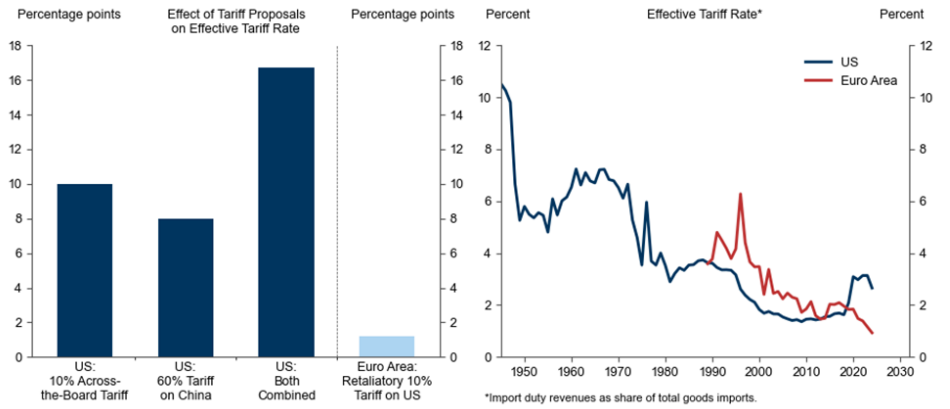
I want to focus on one key aspect of geopolitics, namely the potential impact of a trade war on inflation, growth, and monetary policy in the Euro area and the US.

Let me give you my conclusion up front. While our baseline view in the absence of a trade war is that the ECB and the Fed will lower policy rates by 150-200bp in the next two years, a global trade war could cause greater monetary policy divergence. The reason is that it would likely raise inflation by more in the US but would weigh on growth more in Europe.

As you know, former President Trump has floated tariffs that are large by postwar standards. The main proposals are a 10% surcharge on all US imports and a 60% tariff on imports from China. Taken together, these proposals could raise the average US tariff rate by 16 percentage points to nearly 20%, which would be the highest in the postwar period.

Chart 1

Tariffs Floated by Former President Trump Would Significantly Raise the Effective Tariff Rate



Sources: Department of Commerce, World Bank, Goldman Sachs Global Investment Research.

[1] Goldman Sachs.

1.1 Trade Policy Scenario

There is a lot of uncertainty about what policies former President Trump would impose if he returned to office, and even greater uncertainty about where tariff rates would settle after the inevitable negotiations drama. But to get a reference point, let's investigate the following scenario:

1. The US imposes an across-the-board tariff of 10% on all goods imports.
2. Everyone else (including the Euro area) responds by imposing a 10% tariff on imports from the US.
3. Each government recycles the tariff revenue into tax cuts.
4. The trade war results in a rise in global trade policy uncertainty to the levels observed at the peak of the 2018-2019 trade war. (I view this as a conservative assumption.)

Such a policy change would have important effects on both inflation and growth.

2 Inflation Effects

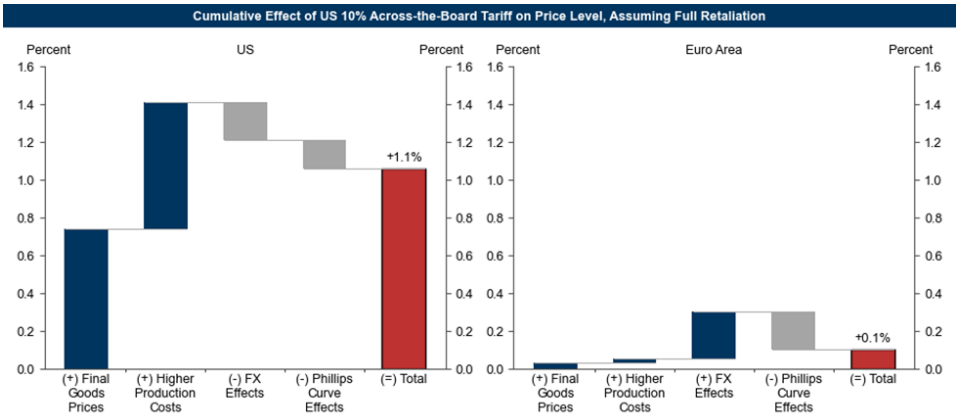
I first discuss the inflation effects. There are four effects to keep track of:

1. A direct boost from tariffs to consumer goods prices.
2. An indirect boost from tariffs to consumer goods prices via higher intermediate goods prices.
3. An effect from likely dollar appreciation induced by the tariffs, which is slightly inflationary in the Euro area and slightly disinflationary in the US.
4. A drag from standard Phillips curve effects resulting from weaker growth in both the Euro area and the US.

Taken together, we estimate a relatively minor 0.1pp boost to Euro area inflation and a sizable 1.1pp boost to US inflation. The reason for the big gap is that the Euro area imports far less from the US than the US imports from the world.

Chart 2

Proposed Tariffs Would Likely Have a Modest Inflation Impact in the Euro Area but a Larger Impact in the US



Sources: Haver Analytics, Goldman Sachs Global Investment Research.

3 Growth Effects

I next discuss the growth effects. There are again four effects to keep track of:

1. A hit from higher prices to real personal income and thus consumption.

2. A partial offset from our assumption that tariff revenue is fully recycled into tax cuts. (The offset is only partial because we assume that the benefit from tax cuts, on average, accrues to a higher income group with lower marginal propensities to consume than the hit from tariffs.)

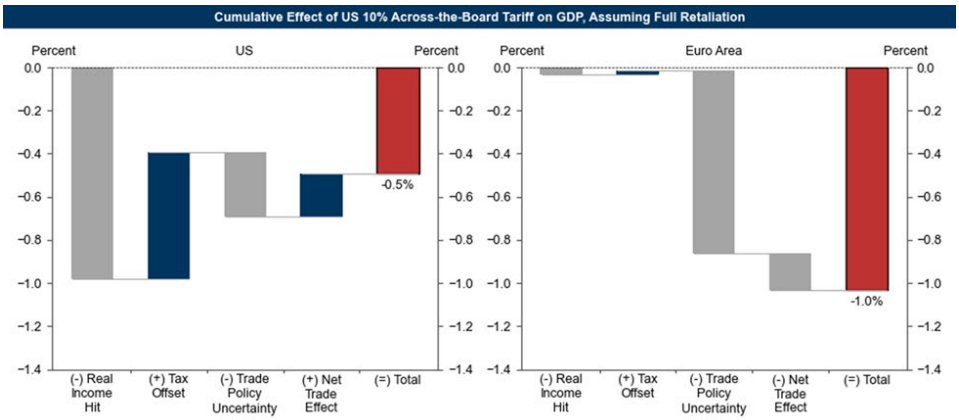
3. A hit from increased trade policy uncertainty to business investment, which I will discuss further in a minute.

4. An effect from changes in net trade, which consists of the effect of tariffs on the relative demand for domestic vs. foreign produced goods as well as the impact of dollar appreciation. We estimate that net trade will have a negative impact in Europe and a positive impact in the US.

Taken together, we estimate a substantial 1.0% hit to GDP in the Euro area and a more moderate 0.5% hit in the US.

Chart 3

Proposed Tariffs Would Likely Lower GDP by More in the Euro Area than the US



Sources: Haver Analytics, Goldman Sachs Global Investment Research.

3.1 Uncertainty Effects

This asymmetry reflects a more negative impact from trade policy uncertainty on investment in the Euro area than in the US. Trade policy uncertainty has recently started to rise again, and would undoubtedly rise much further if a sharp rise in tariffs became imminent.

Chart 4

Trade Policy Uncertainty Rose Significantly During the 2018-2019 Trade War and Has Recently Ticked Up

Sources: Federal Reserve Board, Bloomberg, Goldman Sachs Global Investment Research.

To estimate the impact of trade policy uncertainty on growth, we use three analytical approaches:

1. A firm-level regression of the link between mentions of trade policy uncertainty in quarterly earnings calls vs. changes in investment in both Europe and the US.

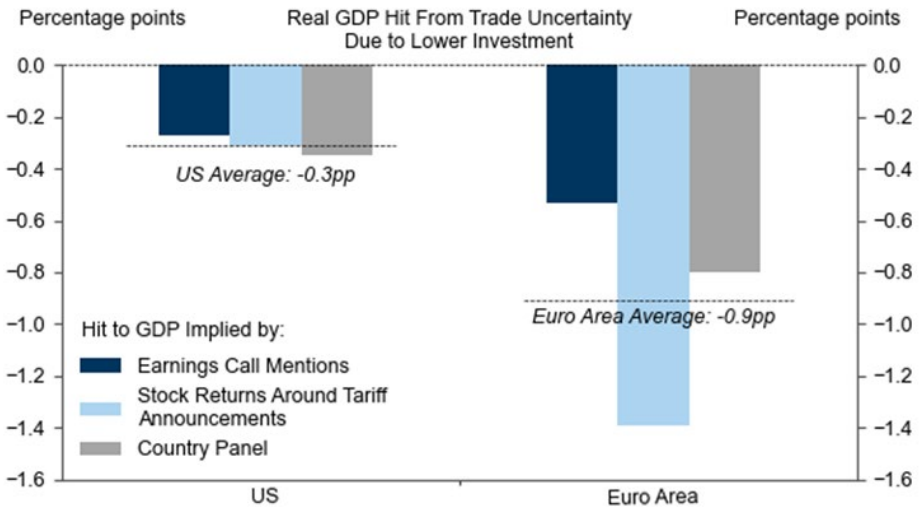
2. A firm-level regression of the link between stock returns around trade policy news events and changes in investment in Europe and the US.

3. A cross-country analysis of the link between trade policy uncertainty and investment growth across 34 countries since 1962.

The estimated effects differ somewhat across approaches, but they are consistently larger in the Euro area. On average across the approaches, we find that a return to the 2018-2019 trade policy uncertainty peak would shave 0.9% off GDP in the Euro area but only 0.3% in the US.

Chart 5

A Rise in Trade Policy Uncertainty to the 2018-2019 Peak Would Likely Subtract More from Euro Area than US Growth



Sources: Goldman Sachs Global Investment Research.

4 Implications for Monetary Policy

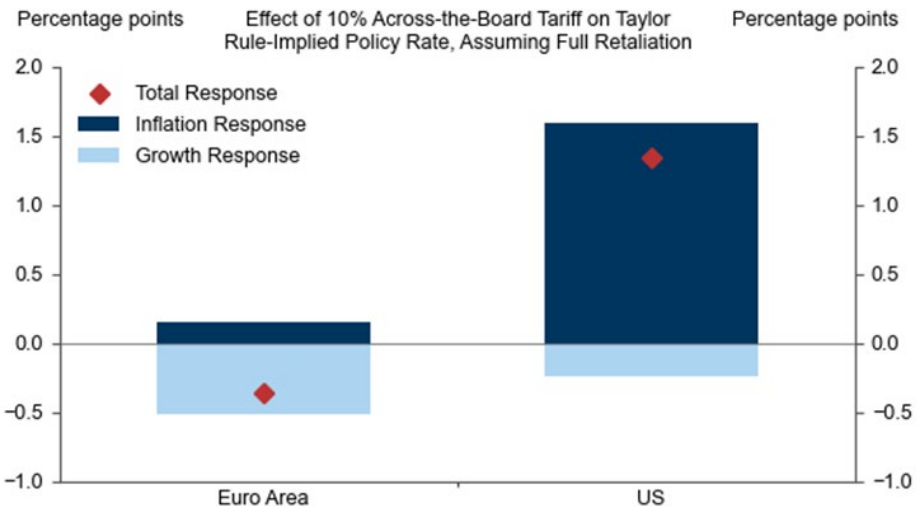
Lastly, I want to discuss the implications of these estimates for monetary policy. To do this, I simply plug the price and GDP estimates into a standard Taylor rule, with coefficients of 1.5 for inflation and 0.5 for GDP.

In the Euro area, the effect is slightly dovish to the tune of -40bp, because the large dovish growth effect outweighs the small hawkish inflation effect.

In the US, the implication is hawkish, to the tune of 130bp, because the large hawkish inflation effect clearly outweighs the smaller dovish growth effect.

Chart 6

Under Standard Taylor Rule, Proposed Tariffs Point to Modestly Lower Policy Rate in the Euro Area but Higher Rate in the US



Sources: Goldman Sachs Global Investment Research.

In considering the hawkish impact on Fed policy, I would note two caveats:

First, the inflation effect of a trade war is really a price level effect. Barring continued escalation, it should drop out of the year-on-year inflation numbers after a year, like the well-known effects of a VAT hike.

Second, there are other important forces—in particular the continued disinflation and labor market rebalancing from the post-pandemic time—which argue for significant Fed rate cuts in a baseline that does not include a new trade war.

Both caveats suggest that a trade war is not necessarily a reason for the Fed to hike rates. It may not even be a reason for the Fed to forego cuts altogether. But if it keeps core PCE inflation above 3% instead of near 2% in 2025, it might well be a reason to delay cuts that might otherwise occur more quickly.

Before closing, I want to reiterate that there is a lot of uncertainty around what would happen to trade policy in a second Trump administration. It is possible that the inevitable trade negotiations would result in tariff levels that are ultimately considerably more minor. In that case, tariffs would be less important for monetary policy than my discussion suggests.

But the uncertainty is two-sided and the trade war could also be considerably more pronounced. A trade war between the US and China would significantly amplify our results, with a bigger increase in US inflation, a bigger hit to European growth, and a stronger case for monetary policy divergence between Europe and the US.