S&P Global Ratings

In the firing line: Trump, trade and EU corporate credit

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Need to know

- The U.S. has given the EU a "final" 30-day reprieve from steel and aluminum tariffs. Should this lapse, EU tariff retaliation is likely. The risk of trade conflict is growing.
- The EU's large trade surplus with the U.S. (dominated by Germany and its car industry) is likely to be targeted for concessions even if U.S.-based production makes this complex.
- The stakes for the European rated sector are high, with some 23% of non-financial investment grade revenues coming from the U.S.

"We lost $151 billion with the European Union last year. $151 billion. It's very hard for us to get our products in, but they send their cars in like Mercedes and like BMW and like lots of other things. We're straightening that out. We're not going to let it go on any longer. We can't let it go on any longer."

U.S. President Donald J. Trump, April 16, 2018[1]

The U.S. visible trade deficit with the EU is the next largest after China

The U.S. has given a "final" 30-day extension of the exemption granted to the EU for section 232 duties – those justified by the effect of imports on national security – of 25% on steel and 10% on aluminum. Should this final negotiation window pass without settlement there is a strong likelihood of WTO-based retaliation from the EU, which has already drawn up two target lists[2] of U.S. goods that will be subject to higher tariffs in response. The broader risk of trade tensions spiraling from skirmish to conflict remains.

The EU's initial response is likely to focus on its 'Part A' list which includes U.S. products worth around €2.8 billion, a reciprocal amount equivalent to the loss of metals exports to the U.S. from tariff imposition. The list includes foodstuffs (rice, sweetcorn, cranberries, orange juice, and whisky), clothing and metal products. The EU is likely to implement these within months of any exemption expiring, on the basis that, in its view, the U.S.'s justification for its tariffs on steel and aluminum is not a valid use of the General Agreement on Tariffs and Trade (GATT) Article XXI national security exception.

The Part B list – estimated to cover another €3.6 billion's worth of goods – would come into play after three years or if a WTO Panel rule the U.S. tariff's invalid and the Trump administration refused to amend them. It is important to understand that WTO rules on retaliation are about reciprocity, rather than retaliation – allowing countries to counter-balance the financial cost of tariffs imposed on them, but not to apply "punishment" – so these counter-measures should not in themselves be seen as an act of escalation in this dispute. That said, it remains to be seen whether the U.S. would accept that.

As the quote above from President Trump suggests, the broader issue is the view taken by the current administration that current trade agreements and practices are not beneficial for the U.S. A visible trade deficit of $823 billion over the last 12 months is taken as *prima facie* evidence of this. While the deficit with China is the largest single element of this trade imbalance, the U.S. deficit with the EU as a whole ranks second and is greater in value than the equally contentious deficit with Mexico (see chart 1). Within the EU, Germany (US$66 billion), Italy (US$33 billion) and France (US$15 billion) are the three largest deficit contributors. In contrast, the U.S. has a small visible trade surplus of US$4.3 billion with the U.K. (see chart 2).

[1] Remarks by President Trump at the Tax Cuts for Florida Small Businesses Roundtable | Hialeah, FL. https://www.whitehouse.gov/briefings-statements/remarks-president-trump-tax-cuts-florida-small-businesses-roundtable-hialeah-fl/

[2] http://trade.ec.europa.eu/doclib/docs/2018/march/tradoc_156648.pdf

Chart 1

Main country elements of U.S. visible trade deficit (US$ Billion, 12 months to February, 2018)

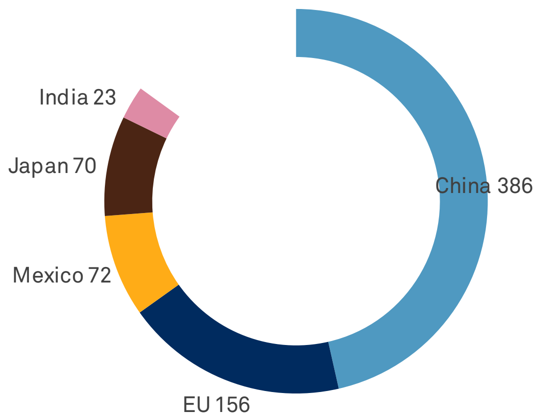
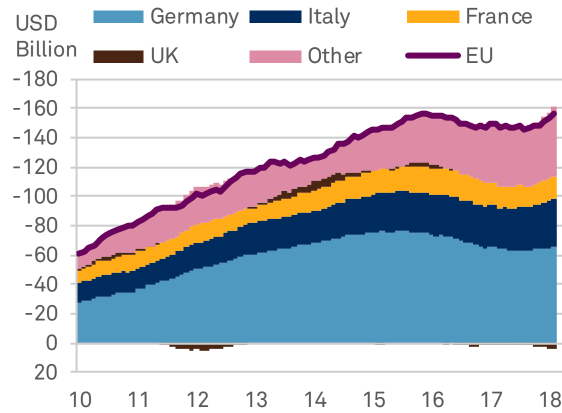


Chart 2

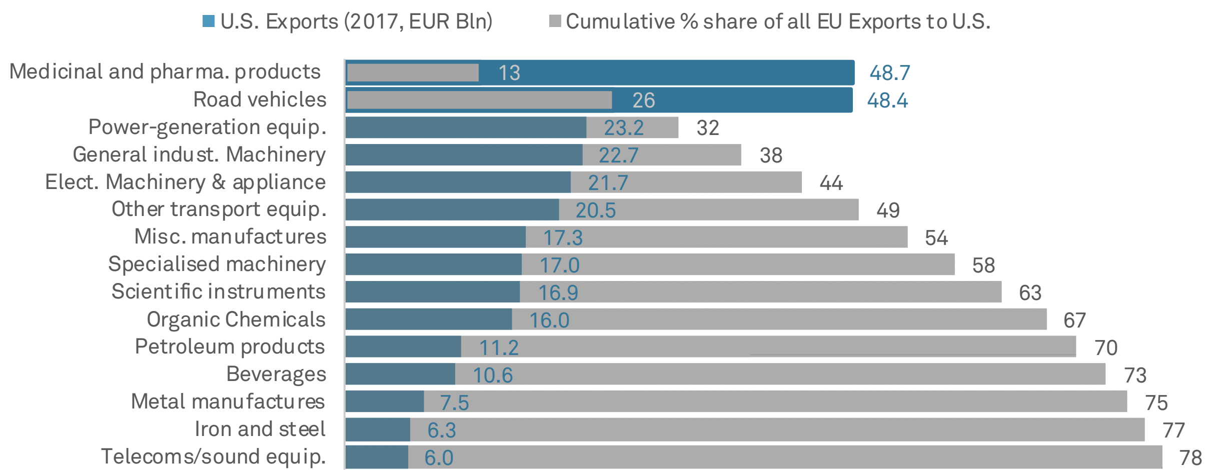
EU visible trade balance with U.S. by country (US$ Billion)



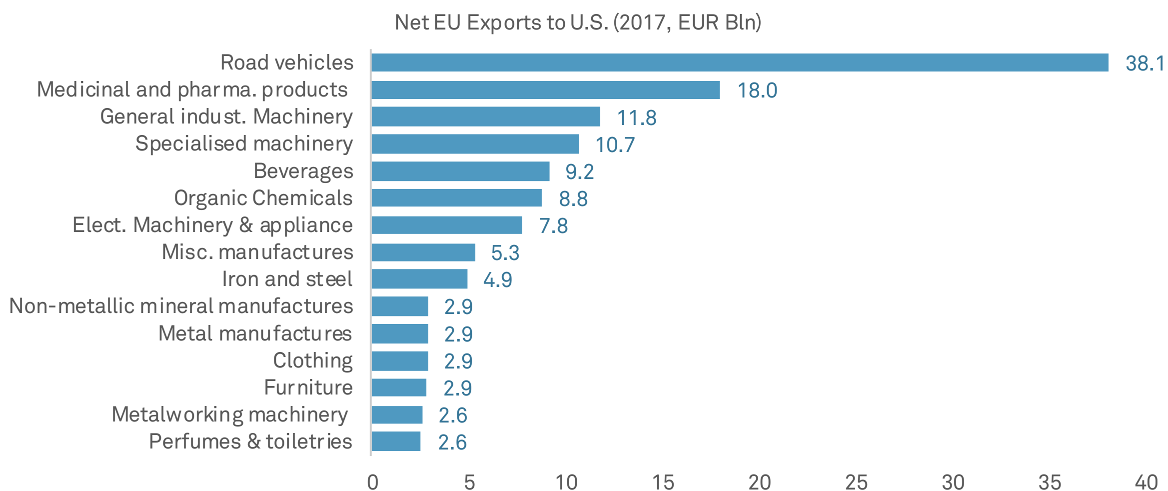
Source: U.S. Census Bureau, Thomson Reuters Datastream, S&P Global Ratings.

Chart 3

Top 15 exports from EU to U.S. by sector (SITC 2-digit classification)



Top 15 net exports from EU to U.S. by sector (SITC 2-digit classification)



Source: Eurostat Comext, S&P Global Ratings. SITC refers to Standard International Trade Classification, a classification system maintained by the United Nations Statistics Division.

Germany dominates EU trade exports

German exports dominate the E.U. trade surplus, especially in motor vehicles

In terms of which industries account for the largest part of this trade imbalance, net export data broken down by Standard Industry Trade Classification (SITC) show **that road vehicles, medicinal and pharmaceutical products, general and specialized machinery, beverages and organic chemicals** represent the largest elements (see chart 3). Together, they account for €97 billion of net exports from the EU to the U.S.

Chart 4 uses U.S. Census Bureau data to show how the EU's net exports in these six industries are distributed across the trade bloc's largest countries. The stark reality of Germany's dominant trade performance within the EU is clear – it accounts for the largest net export contribution for five out of six of these sectors, with the motor vehicle component the single largest surplus. Other notable surpluses exist for **British and Italian motor vehicles and French and Italian beverages**. But, as President Trump's comments spell out, it is German car exports that are the main engine of EU export success and, consequently, the most likely area to be targeted should trade tensions escalate. Tariff differentials are a bone of contention, with U.S. cars imported to the EU subject to 10% tariffs versus 2.5% in the other direction. However, truck and pickup vehicle imports into the U.S. are subject to 25% tariffs.

Chart 4

Net exports to U.S. in 2017 for SITC 2-digit sectors with the largest overall trade surplus with U.S. for selected European countries (US$ Billion)

Source: U.S. Census Bureau, S&P Global Ratings.
Positive values indicate that the relevant country had a trade surplus for 2017 as a whole with the United States in that product category; negative denotes the reverse.
Note that size of bars is not equal across product lines – bars are scaled to emphasize largest net export position per SITC category by country.

Rated entity revenue exposure to the U.S.

A full-blown trade war between the EU and the U.S. would be extremely costly for both parties. Sales in and to the U.S. represent a large share of the total revenues of European non-financial corporate entities rated by S&P Global Ratings. We estimate that 23% of revenues for investment grade (IG) companies are derived from the U.S., with health care, business and consumer services, media, and hotels, restaurants and leisure having the largest exposure (see chart 5). Of 19 IG sectors, 11 achieve over a fifth of their sales in the U.S. For autos, the figure is 24%. Speculative-grade exposure is less, but still significant, with 14% of revenues coming from the U.S., and with notably high sector exposures in healthcare, business and consumer services, capital goods, and media (see chart 6).

U.S. accounts for 23% of European non-financial IG revenues and 14% for SG

Chart 5

Estimated U.S. revenue as proportion of total revenues for European non-financial corporates rated Investment Grade by S&P Global Ratings

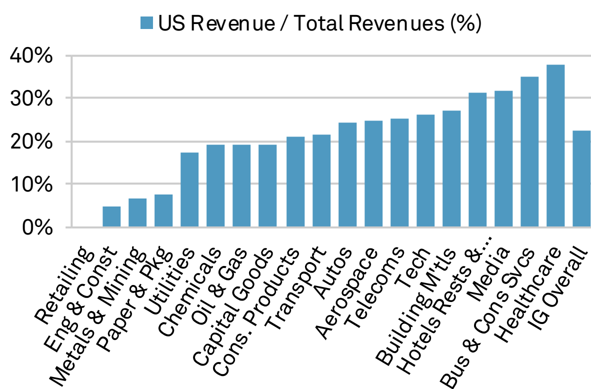
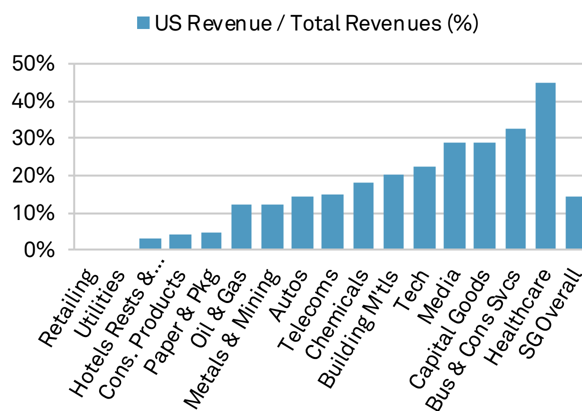


Chart 6

Estimated U.S. revenue as proportion of total revenues for European non-financial corporates rated Speculative Grade by S&P Global Ratings



Source: S&P Global Market Intelligence, S&P Global Ratings
Note that values are estimates based on publically available geographic segment data and private estimates by S&P Global Ratings. Figures only reflect the data for those entities with available or estimated data. Not all companies disclose the relevant data.

The complexities of cars and tariffs

While the size of the EU's vehicle trade surplus with the U.S. makes it a likely area to be targeted, taking action would be difficult for a number of reasons:

A U.S. trade attack on EU car imports would be complex and partly self-defeating

- Large numbers of vehicles from European companies are actually built in the U.S. German manufacturers produced 804,000 cars in the U.S. in 2017, which compares with an export total (Germany to U.S.) of 494,000 cars. Moreover, of this U.S.-based production, more than half of it is exported – some 430,000 units last year. This means that U.S. produced cars under German badges could be caught in the crossfire of tariff impositions and U.S. employees and suppliers might be adversely affected. For example, China has threatened to double its duties on U.S. car imports to 50% in response to the section 301 action.
- It should be noted that there are significant variations across European manufacturers in terms of their U.S.-based production. BMW has significant production capability there, for example, while Audi, Porsche, and Jaguar Land Rover do not.
- The U.S. route to trade action so far has followed, nominally at least, legal routes – use of section 232 of the Trade Expansion Act of 1962 for metals tariffs and section 301 of the Trade Act of 1974 for action on alleged Chinese intellectual property rights infringement. Applying higher tariffs on European cars would be a more difficult legal proposition for the U.S., certainly if European imports alone were singled out. U.S. auto manufacturers have significant auto production capacity in Canada and Mexico and these would be subject to import tariffs unless they were exempted. But such exemptions might be subject to legal challenge via the WTO and could give grounds for significant retaliatory measures by the EU.

Euro strength and rising German labor costs may erode trade surplus

Euro strength and rising wages may naturally reduce the EU trade surplus

While the current size of the EU surplus with the U.S. is attracting ire, there are some grounds for expecting this to shrink over coming years without trade measures being invoked. **One natural adjustment factor is the exchange rate**. For example, although the smoothed trend (three-month moving average, year on year) of seaborne passenger vehicle imports into the U.S. from the EU has seen a recent surge, they were contracting as recently as October (see chart 7). The surge may represent pre-emptive imports to avoid tariff measures, but it is interesting to note that there is a good correlation between the key U.S. Dollar exchange rates for European auto exporters (Euro, British Pound, and Swedish Krona) and vehicle import trends (see chart 8). Put simply, recent U.S. dollar weakness makes European cars more expensive and rising prices are likely to slow import demand.

Chart 7

U.S. passenger vehicle imports from EU are rising at close to 10% year-on-year...

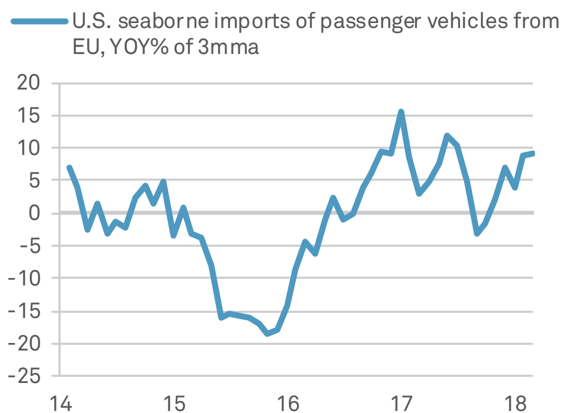
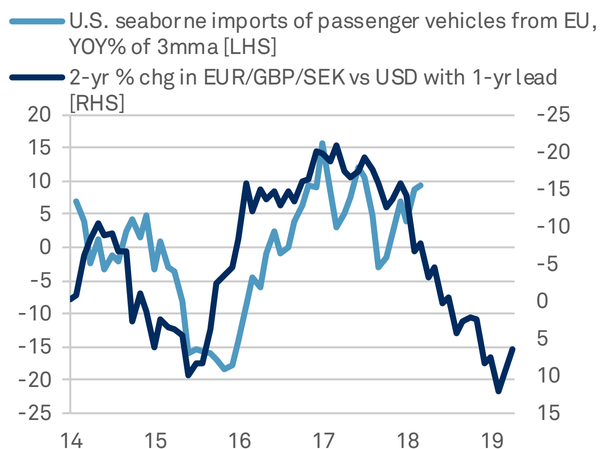


Chart 8

...although recent US$ weakness may prove a natural brake over the next year, irrespective of trade policy



Source: Panjiva Research, Thomson Reuters Datastream, S&P Global Ratings
The composite change in EUR, GBP and SEK spot rates versus USD (U.S. Dollar) is weighted by relative share in seaborne passenger vehicle shipments from January 2013 to March 2018.

Another adjustment process comes through relative labor cost trends. Germany's long boom is starting to create significant upward pressure on wages and recent wage agreements (see table 1) including a 4.3% wage increase for Volkswagen staff and the same rate for the broader and influential IG Metall agreement. In S&P Global Ratings' view, these increases are likely to be in excess of achieved labor productivity growth and, in conjunction with the strong euro, are likely to hurt Germany's export competitiveness.

Conclusion

President Trump's *Contract with the American Voter* was quite explicit in its intentions to change U.S. trade policy through renegotiating or abandoning the North American Free Trade Agreement (NAFTA), withdrawing from the Trans-Pacific Partnership (TPP), and attacking perceived foreign trade abuses. China and NAFTA have received much of the administration's early attention, but the EU's substantial trade surplus with the U.S. means that it is also in the firing line for trade measures. The possible imposition of higher steel and aluminum tariffs on national security grounds would mark the opening salvo.

The initial exemption from these tariffs granted to allies has expired, with a "final" 30-day reprieve being granted to the EU (plus Australia, Argentina, and Brazil in anticipation of agreements on metal exports[3]). Should this window not result in a settlement and the metals tariffs be imposed, the EU is likely to impose retaliatory measures bringing the risk of a broader and escalating trade dispute.

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[3] As part of a broader bilateral trade renegotiation, South Korea has already agreed a quota on its steel exports to the U.S. equal to 70% of its average annual shipments to the U.S. between 2015 and 2017 and is still subject to the aluminum tariff.

The stakes for the European rated sector are high. We estimate that 23% of the revenues of European non-financial corporate entities rated investment grade by S&P Global Ratings come from the U.S. and 14% for speculative grade. This is not just dominated by one sector: 11 out of 19 IG sectors earn over a fifth of revenues in the U.S.

Although corporate exposure is broad, the EU visible trade *surplus* is concentrated in a few key industries and is dominated by Germany. German auto exports are thus a critical battleground, particularly given tariff differentials. The difficult relationship between President Trump and Chancellor Merkel does not help. That said, it will be difficult for the U.S. to impose tariffs on the European auto industry without breaching its WTO obligations. Worst-case outcomes would require a more fundamental erosion of the rules-based international trade system than seems likely at present. Moreover, with significant European-owned production in and car export from the U.S., higher tariffs could be self-defeating. In the medium term, the EU's trade surplus might start to shrink of its own accord, reflecting the lost competitiveness brought about by euro strength and significant wage cost inflation in Germany.

Table 1

Selected German Wage Agreements 2018

Sector	Sector size	Wage increase		Duration
		Bid	Agreed	
Energy (Nordrhein-Westfalen)	56,000	5.0%	2.2% (01/2018) + 2.1% (01/2019)	24 months
Manufacturing: Wood and Plastic (Baden-Wuerttemberg)	33,300	6.0%	4.0%	21 months
Manufacturing: Metal and Electronics	3,499,200	6.0%	4.3%*	24 months
Volkswagen	120,000	6.0%	4.3%*	24 months
Deutsche Post	130,000		3% + 2.1% (10/2019)	28 months
Agriculture	350,000		3.0% + 2.5% (2019) + 1.5% (2020)	36 months
Public Service	2,300,000	6.0%	3.2% (3/2018) + 3.1% (4/2019) + 1.1% (3/2020)	30 months
Restaurant, Hotels	1,794,000	6.0%		
Construction	699,000	6.0%		
Manufacturing: Wood and Plastic	198,000	6.0%		
Transport (Brandenburg)	3,200	6.5%		

Source: WSI, S&P Global Ratings.
* In addition, 27.5% of a month's salary in August 2019.

Related Research

- The potential impact of higher wage settlements on Germany's trade balance, April 24, 2018
- Economic Research: the U.S. economic outlook is solid, but will trade tensions have the U.S. trading places soon?, March 29, 2018
- Global trade at a crossroads: if U.S. tariffs trigger a trade war with china, corporate credit will suffer, March 24, 2018
- Economic research: what will be the likely impact of U.S. steel and aluminum tariffs on Latin America?, March 20, 2018
- S&P Global economists release a "field guide" to a potential Sino-U.S. trade war, March 19, 2018
- Credit FAQ: Japan's top steelmakers can withstand U.S. tariffs and increasingly aggressive investments, March 12, 2018
- Global trade at a crossroads: U.S. steel and aluminum tariffs raise risk of retaliatory spiral, March 9, 2018
- Global trade at a crossroads: U.S. steel and aluminum tariffs will likely have small direct impact but risk larger knock-on effects, March 9, 2018
- Trump tariffs forge better credit quality for U.S.-based steel and aluminum producers with a protectionist stance, March 2, 2018
- De-globalization could disrupt U.S. supply chains, May 30, 2017

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