

Dialogue &co episode 4 (2/2) – The return of protectionism – US measures and consequences

VOICE-OVER

Welcome to Dialogue &co. In this second episode on protectionism, recorded on 7 February 2025, Hervé Le Bihan, Director of International Economics and Cooperation, and Antoine Berthou, Head of Division, International Macroeconomic Studies, answer questions from Lucile Rive, podcast production manager for the Banque de France. They apply their economic insight to an analysis of the consequences of US trade policy. Enjoy the podcast.

LUCILE RIVES

Hello, Hervé Le Bihan.

HERVÉ LE BIHAN

Hello, Lucile.

LUCILE RIVES

Hello, Antoine Berthou.

ANTOINE BERTHOU

Hello.

LUCILE RIVES

In the first episode, we provided an overview of free trade. Now, we're going to focus on the heart of the matter and return to what's happening in the United States. What can a country like the United States expect from heightened tariffs, Hervé Le Bihan?

HERVÉ LE BIHAN

Well, firstly, tariffs are a source of state income. Historically, until the beginning of the 20th century, tariffs provided an important source of income for the US federal budget. But this is much less the case now. For Donald Trump, tariffs provide a means to finance some of his fiscal measures, such as tax cuts.

Secondly, raising tariffs is intended to help US companies be more competitive. The prices of imported goods go up making the prices of US products more attractive. The stated objective is to boost US production in specific sectors, such as the automotive industry, and thus rebalance the United States' foreign trade.

However, it's important to bear in mind that these two objectives – increasing tariff revenues and improving the situation of US companies – are to some extent contradictory.

Because if tariffs lead to a sharp drop in imports in favour of local US products, then customs revenues will decrease mechanically. Furthermore, the exporters targeted by protectionism may absorb the tariffs by reducing their margins. In this scenario, the competitiveness of US companies will only see a slight improvement.

LUCILE RIVES

And then there is a more political, even geopolitical, aspect to the way Donald Trump perceives tariffs.

HERVÉ LE BIHAN

Precisely. There is a third aspect – a third objective – to Donald Trump's intentions to increase tariffs. In this case, tariffs are being brandished as a threat to obtain geopolitical concessions. And this strategy is very much a part of the politics of the new Trump administration. It has notably led to threats of tariffs in quick succession against Colombia, Mexico and Canada in order to obtain concessions in the fight against drug trafficking or illegal immigration.

LUCILE RIVES

So Hervé, you have already pointed out a contradiction. Customs revenues only exist if imports are maintained. Will the measures announced by Donald Trump enable him to achieve his objectives? Or are there economic effects associated with heightened tariffs that could work against his stated ambitions?

HERVÉ LE BIHAN

Well, on an economy-wide scale, the usefulness of tariffs is far from certain. Because on the one hand, we can expect prices to rise for consumers in the United States if nothing else is changed. It's likely that all or part of the increase in tariffs will be reflected in the prices of retail products and this increase in the retail price of imported products will push down Americans' purchasing power and probably their consumption. The same reasoning also applies to the consumption of intermediate inputs purchased by US companies, especially in a context of highly integrated value chains where goods can cross the border several times. This is the case for the automotive industry between the United States, Canada and Mexico, for example.

And then, there is the appreciation of the US dollar.

LUCILE RIVES

Right. And how exactly do we explain the link between imposing tariffs and the appreciation of the dollar?

HERVÉ LE BIHAN

An important factor here is the monetary policy response. The rise in the price of imports creates extra inflation. And to counter this risk, the Federal Reserve – the US central bank – would be likely to raise interest rates. This would increase the yield on dollar-denominated assets relative to the rest of the world, which would lead to an appreciation of the dollar as

investors demand more of these types of assets. And through anticipation effects, the dollar could go up even before the tariffs are applied.

LUCILE RIVES

So Antoine, how does this appreciation of the dollar compromise Donald Trump's objectives?

ANTOINE BERTHOU

An important objective for the US economy, and therefore for the 2024 presidential campaign, is to reduce the trade deficit, and thereby reduce the United States' economic and macroeconomic dependence on the rest of the world, and particularly China. For this to happen, imports must react adversely to the increase in tariffs. Higher tariffs lead or must lead to a decrease in the volume of imports into the United States, particularly from Europe and other targeted countries, such as China.

But, and as Hervé just mentioned, one mechanism that would undermine this objective is the appreciation of the dollar. Now, the monetary policy response to rising inflation in the United States should lead to an appreciation of the dollar. It's a fairly well-known mechanism. And this appreciation would offset the effect of the rise in import prices by improving the purchasing power of households. So an appreciating dollar gives US households and businesses more purchasing power. Consequently, there is less of an adjustment in import volumes.

This result can be seen in the macroeconomic data on the trade war between the United States and China between 2017 and 2020. Our work at the Banque de France shows that between spring and autumn 2018, the US administration, and particularly Donald Trump via his tweets at the time, gradually announced the implementation of taxes on USD 300 billion of imports from China. These announcements resulted in an appreciation of the dollar against the Chinese renminbi of around 10% over that same period and even before the tariffs were applied. The effects were widely anticipated. And the empirical relationship is rock-solid. In anticipation of tariffs, the dollar appreciates, which reduces the adverse impact of tariffs on import volumes.

When imported goods are invoiced in US dollars, it's true that the transmission of exchange rate variations to the import price may be weak in the short term. But over a one-year time horizon, it's in the exporter's interest to reduce its export price in dollars to offset the increase in customs duties and maintain its market share unchanged. So in the end, it amounts to much the same thing: the rise in the cost of imports for households and businesses in the United States is cushioned, and there is relatively little reaction from imports.

Now, from a macroeconomic point of view, we also find that over the same period, the United States' external trade did not improve. Therefore, the current account deficit, or the US trade deficit, was not reduced. So economists think that there is a macroeconomic and accounting relationship between the external imbalance and macroeconomic savings in the

United States. The external deficit is more a function of a balance or imbalance between savings and investment than of customs duties. And so, to restore the balance, the United States must increase its net savings, which it can do by reducing the government deficit, for example.

LUCILE RIVES

So in fact, the trade deficit doesn't rebalance because the United States, the Americans, consume a lot?

ANTOINE BERTHOU

Exactly. For it to rebalance, they have to save more. For example, there are countries such as Germany or China that structurally have an external balance surplus, simply because they have a savings surplus. This savings surplus translates into less consumption, less investment and therefore a surplus on their external balance. Countries such as the United States and even France, on the other hand, have something of a savings deficit, consuming or investing more than they save. And from a macroeconomic and accounting point of view, this translates into an external deficit.

LUCILE RIVES

Hervé, Antoine mentioned the fact that exporting countries were going to have to adjust their prices. But isn't it in the interest of these countries to react? And ultimately, could the US economy lose out?

HERVÉ LE BIHAN

Yes, Lucile, absolutely. How the targeted countries react could work against the United States' objectives. In fact, tariffs can be advantageous to the countries that raise them in the short or medium term, particularly if the targeted countries do not retaliate, because domestic production will replace foreign production. But if they do retaliate, we find ourselves in a situation that economists call the prisoner's dilemma. That is, that each country reacts according to its own immediate interests, but ultimately it leads to a solution that is sub-optimal and worse for everyone than a cooperative solution. It's a lose-lose situation. During Donald Trump's first term of office, European countries and China showed that they were able to push back against the increase in US tariffs. In Europe, for example, tariffs were imposed on highly symbolic US export products, such as motorbikes, jeans, bourbon and cranberries. So very recently, during this first week of February 2025 that saw these announcements from the United States, China announced an increase in tariffs targeting the United States in return. But it also announced measures targeting the activities of certain major US tech groups, as well as restrictions on its own exports of certain critical minerals. Which also shows that the retaliation can take different forms and go beyond the strict framework of tariffs. A trade war can, in fact, be multifaceted.

LUCILE RIVES

And this idea of relocating industries. Is it a real risk? Can it really be in their interest to relocate?

ANTOINE BERTHOU

I think we underestimate the ability of world trade and businesses to reorganise flexibly in response to the constraints of a changing world, whether from a geopolitical perspective or via trade policy, which is more conventional with regard to commerce. There is a result or a mechanism found in studies on international trade, known as “tariff jumping”: we jump over the trade barriers to try to avoid them. And we can do this in different ways. In 1980s Japan, Japanese car exporters reorganised their production chain to try to get around these tariff barriers. And so we see today, in the context of what is also called geopolitical fragmentation, if we go beyond the strict framework of a trade war, Chinese exporters or goods produced in China are going to pass through different countries, notably Vietnam and Mexico, to try to get around the trade barriers. This is one of the reasons for the US authorities’ annoyance in the context of this trade war.

LUCILE RIVES

Hervé, we’ve talked about the consequences for the United States of the protectionist measures that were being considered. But what consequences would there be for other countries?

HERVÉ LE BIHAN

First of all, not all US partners will be impacted in the same way. It will depend on the respective increase in the tariffs that affect them and their respective exposure to the United States. For example, nearly 80% of Mexico and Canada’s exports go to the United States. For both these countries, a trade war with the United States would be extremely damaging for business, particularly in the short term. In the medium term, trade relations could realign geographically to a certain extent, but in any case, that takes time.

LUCILE RIVES

And more specifically, Antoine, how exposed are French and European businesses?

ANTOINE BERTHOU

On the whole, European countries are less exposed to the risk of a trade war with the United States than Mexico and Canada simply because of their relative geographical distance. The United States accounts for approximately 7.5% of French exports of goods, which is less than Germany and Italy, which are at around 10%. So 10% of Germany and Italy’s exported goods go to the United States. For the United Kingdom, it is around 13.5%. For Japan, 20%. So France and the European countries tend to be a little less exposed.

But despite that, a trade war would represent a risk to activity in the short term in the euro area, particularly in certain more exposed sectors. For example, Germany’s automotive, machinery and chemicals sectors are very exposed as their exports are concentrated in the United States. The most exposed sectors in France are aeronautics, chemicals, pharmaceuticals and agri-food, particularly beverages. So this gives us a little insight into which sectors in France would be most sensitive to this trade war.

LUCILE RIVES

Hervé, beyond this sectoral approach, at the macroeconomic level, what can we expect from this trade war in France and in the euro area?

HERVÉ LE BIHAN

At this stage, at a macroeconomic level, it's quite difficult to quantify the losses that a trade war with the United States would inflict on Europe, because there are so many tariff scenarios and possible responses. Having said that, we can identify several primary mechanisms. Firstly, the effect on activity will most likely be negative. This is due to the decline in exports as a result of the reduced competitiveness of European products on the US market as US tariffs push up the prices of European goods. For example, we expect that a 10% duty on French wine would be passed on to the price paid by consumers in the United States. But the type and scale of the impact would also depend on how tariffs on the United States' other partners – and therefore on our competitors in the market – evolve. If tariffs increase on Chilean or Australian wines, for example, this would soften the adverse effect on the competitiveness of French wines. And in the end, American consumers could well buy more Californian wines as their prices would probably remain the same, but French wines would not lose out in terms of competitiveness compared with wines from third countries.

LUCILE RIVES

And does the effect on activity in the euro area also depend on the retaliatory measures from the United States' trading partners that we talked about earlier?

HERVÉ LE BIHAN

Absolutely. If the European Union imposes higher tariffs on US goods, the price competitiveness of European companies on the European market will improve. Conversely, in sectors that are heavily dependent on intermediate inputs imported from the United States, such as aeronautics or other high-tech intensive sectors, higher tariffs would result in higher production costs.

Finally, another aspect of a trade war scenario is that we must consider how partner countries targeted by US tariffs will shift their exports. In particular, we can expect China to shift its exports to Europe with lower prices and probably a very negative impact on our competitiveness. So on a certain level, even if the United States only targets China and not the European Union, it can still indirectly affect the EU.

LUCILE RIVES

Hervé, we were talking earlier about the role played by the reaction of the dollar exchange rate. How can this have an effect on the severity of Europe's macroeconomic losses?

HERVÉ LE BIHAN

Now we return to the mechanism that Antoine mentioned earlier, that of a depreciation of the euro against the dollar strengthening the competitiveness of European companies. And this would offset the adverse effect of tariffs in the United States.

LUCILE RIVES

A final issue that greatly concerns central banks, and also consumers, is inflation. What inflationary prospects can we in the euro area expect from this unfolding trade war?

ANTOINE BERTHOU

The effect may be slightly inflationary or slightly deflationary, depending on the scenario. We have these two mechanisms that offset each other. On the one hand, there is the direct effect of the increase in import prices, which will lead to price rises in the euro area. But on the other hand, this is offset by a decrease in activity, which will have the opposite effect. Because of that, we think that the effects on inflation will be rather muted.

HERVÉ LE BIHAN

And the shift of Chinese exports to the European Union, which we spoke about earlier, will have a disinflationary, even deflationary effect. All in all, we don't have a quantitative scenario, but there are clearly two offsetting effects. And ultimately, we don't expect this trade war to add to inflation in the euro area.

LUCILE RIVES

And finally, what in particular makes the Banque de France, and the Banque de France's economists, so interested in the question of protectionism?

HERVÉ LE BIHAN

As a stakeholder in the Eurosystem, the Banque de France – together with the European Central Bank and the other euro area national central banks – contributes to the development of euro area monetary policy. And one monetary policy objective is to maintain a stable inflation rate of 2% over the medium term. Therefore, in order to draw up our macroeconomic projections and to calibrate monetary policy, it is essential that we examine all economic policies and shocks likely to influence the trajectory of inflation and activity in France and in the euro area. And the shocks of Trump's tariffs certainly form a part.

And the Banque de France, which is responsible for establishing France's balance of payments, also prepares analyses of France's foreign trade. The consequences of any future tariff increases on French foreign trade will of course be analysed from this perspective.

LUCILE RIVES

A little self-promotion there!

HERVÉ LE BIHAN

And why not.

LUCILE RIVES

Thank you, Hervé Le Bihan.

HERVÉ LE BIHAN

Thank you, Lucile.

LUCILE RIVES

Thank you, Antoine Berthou.

ANTOINE BERTHOU

Thank you.

VOICE-OVER

Thank you to all our listeners. A huge thank you to Hervé Le Bihan and Antoine Berthou for taking part in this episode of Dialogue &co. If you enjoyed this episode, please leave us your comments and stars on your podcast listening platforms. See you soon for the next episode of Dialogue &co.