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The New Realpolitik

Europe needs to understand Trump before it can calibrate an appropriate response.

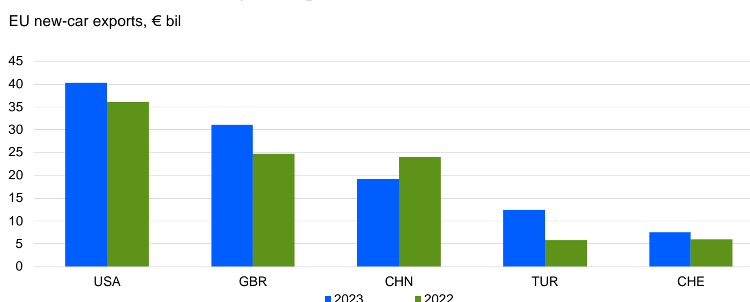
- From trade to defence, Europe has come under fire from the U.S. in the last couple of weeks.
- The U.S.'s motives are not entirely clear, making it difficult to calibrate a response.
- Attacks on Europe's economy and its political stance are part of the new *realpolitik*.

The U.S. has opened fire on Europe. A deep sense of dissatisfaction around the EU's surplus in auto exports has widened to an attack on the European tax system, leading to a declaration of intent to impose 25% tariffs on European cars, pharmaceuticals and semiconductor exports. Talks with Russia over the future of Ukraine are progressing without Europe at the table together with an attempt to secure Ukraine's mineral wealth. It's understandable that European policymakers are reeling, because the objectives of its once stalwart ally are not easy to understand. In the current world of *realpolitik*, U.S. interests clearly do not align with those of Europe, but at the same time, it is not straightforward for Europeans to decipher what those interests are. This makes any European response harder to calibrate. We look at the economic implications of some of the recent statements and actions that affect Europe.

Europe's car tariffs

Trump's avowed dissatisfaction over EU tariffs on U.S. cars has a point. The EU levies 10% tariffs on cars imported from the U.S. while the tariff rate for cars going the other way is 2.5%. The 10% is the EU's default position on cars for any country with which it does not have a trade agreement. A previous attempt to sign a trade agreement with the U.S. ended in failure back in 2016 after meeting with political opprobrium on both sides of the Atlantic, thus ending any hope of eliminating EU tariffs on U.S. car imports.

The problem is that tariffs are bad for the U.S. economy. Tariffs push up prices, lead to tighter monetary policy, hurt demand and, ultimately, jobs. Tariffs also hurt European car manufacturers, so it really feels like a lose-lose situation. Europe's car industry is already in a vulnerable position, and manufacturers will certainly not want to face a cost disadvantage in their largest export market.



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Perhaps Trump does want the EU to reduce tariffs on U.S. car imports, but reducing tariffs on U.S. imports may not give Trump the win he seeks. The EU signed a trade agreement with Japan in 2018, which brought in a phased reduction of car tariffs. But eyeballing the data does not reveal a big jump in Japanese car imports subsequently into the EU—in fact, quite the opposite. Between 2017 and 2022, imports of Japanese cars into the EU declined by 30% in volume terms, despite the reduction in tariffs. This is a very cursory analysis of course, but it does support the view that reducing tariffs does not always lead to an increase in imports. Accordingly, despite the 10% tariffs on U.S. cars, import volumes of U.S. cars into the EU increased by 10% over the same period.

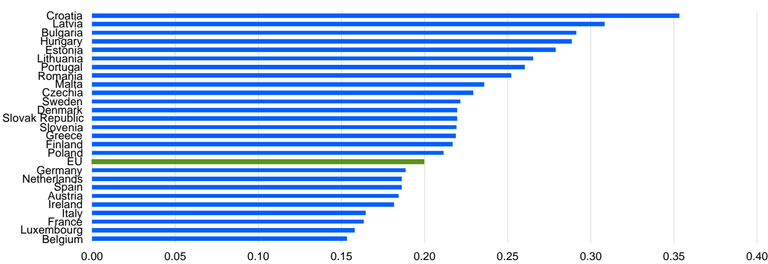
The story is much more complex in a globalized economy where the country associated with a brand is often not the country where the car is produced. Take Tesla as an example. It produces a number of cars in China that make their way into Europe. The EU imposed tariffs on Chinese electric vehicles in 2024 and, as part of the package, planned to levy close to 21% on Chinese-made Tesla cars. In the final reckoning, this was lowered to 9%, but reducing tariffs on imports from the U.S. in an attempt to appease Trump will presumably not include Teslas made in China.

The bigger question is whether the complaint is just about cars or whether this is an attempt to dismantle Europe's economic structure. Time will tell.

Europe's tax system

A further complaint is that U.S. car producers (and also the other industries mentioned by Trump) face an additional disadvantage because of Europe's value-added tax system. U.S. car manufacturers face a 10% tariff in the EU, but car sales also attract VAT, which, in Trump's view, is a double whammy. But the motivation for complaining about VAT is not clear. There may be a genuine misunderstanding about the nature of VAT and tax policy in the EU, VAT may simply be another bludgeon to beat the EU with, or it may even be an attempt to get the EU to change its tax system.

VAT is a consumption-based tax that all EU countries levy. Certain goods are exempt, and the VAT rates vary, depending on country and class of good. But, by its very nature, it aims to create a level playing field, that is, a consumer has to pay VAT on a car purchase in the EU, regardless of the country of origin or the brand of car. Moreover, VAT is an integral part of the tax system and accounts for approximately 20% of the tax take across the EU.



There could be a broader point that VAT discourages car ownership and inhibits sales of drugs and chips. But then the argument should apply to all taxes that Europe uses that work the same way. In the case of cars, VAT is one of several taxes Europeans have to pay for the privilege of car ownership, and the complaint should be broader. Fuel taxes hurt much more—especially as they are paid per litre of fuel consumed—and then there are other taxes such as sales and registration taxes and ownership taxes. According to the 2022 Tax Guide published by ACEA, the European Automobiles Manufacturer's Association, total tax revenue collected across 14 EU member states (including the largest states) from vehicles was approximately €375 billion, of which VAT on car sales accounted for 31%, while fuel duties were 61%. The data are incomplete and not perfectly aligned, but the underlying message is correct: Europeans pay a lot to own and run a car, any car!

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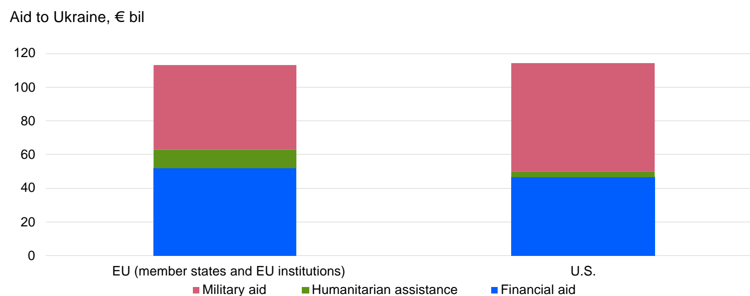
Given the neutral nature of indirect taxes, the U.S. should really begrudge any tax that makes car ownership in the EU a more expensive proposition than in the U.S. Or perhaps, the U.S. should accept that the car market in Europe differs from that in the U.S., and rather than attack the European tax system, U.S. car manufacturers should make their cars more attractive to European consumers.

In any case, it is unlikely that the EU will eliminate the VAT on cars (or even fuel taxes) because of this complaint. Indirect taxes serve as significant sources of revenue for governments, and eliminating or reducing such taxes would lead to fiscal and ultimately economic problems. The resulting decline in demand in the EU would be negative for U.S. car exporters.

Feeling defensive

The future of Europe's security is closely tied to the discussion around the future of Ukraine. Team Trump has barreled ahead in the past week with total disregard for Europe's position, leaving European leaders bewildered and scrambling to offer a credible response. A major sticking point has been U.S. support for Ukraine, coupled with the long-standing complaint that European nations don't spend enough on defence, but it is worth noting that at least as far as the Ukraine crisis is concerned, the EU has spent more.



Just as noteworthy is the composition of this support, because a substantial amount comes from the EU and its institutions and not from member states' budgets. The U.S. has persistently complained that European countries don't spend enough on defence. But, as the Ukraine crisis shows, looking at European security spending just through the lens of member state spending is limiting. The EU and its institutions have played a vital role in providing support for Ukraine, and any collective European response that leads to greater defence spending will also have to involve the use of EU funds.

Europe's immediate response to Trump's recent comments has been to create a €6 billion military package for Ukraine. It is also considering repositioning €93 billion of unused pandemic recovery funds for defence. There are other options on the table, including a European rearmament bank or a special fund to which non-EU countries could also contribute.

But the volume of funds required is unclear as is the U.S. interest in enduring peace in the region. The extent of future participation of the U.S. in European security is in doubt and may, in part, depend on whether Trump can secure a deal on minerals with Ukraine. Rather than be interested in peace, the U.S. may be primarily interested in securing Ukrainian assets, leaving the Europeans to bear the costs of peace-keeping as well as security jitters. For Europe, single-handedly funding Ukraine risks exhausting EU borrowing capacity and reduces the capability of the EU to deal with future crises. This might affect the yields of more vulnerable EU member states.

But all is not necessarily negative. Jump-starting a European defence industry requires significant investment, which will be good for growth. Because catching up with the U.S. in terms of defence capability will take a number of years, the immediate tactical response to support Ukraine and boost domestic security could be to buy more U.S. weapons. This may be viewed favourably by the U.S. not only because this supports the U.S. defence industry, but because it also reduces the EU's bilateral trade deficit. Could this be a negotiating tactic for Europe to deploy?

Uncertain peace dividend

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The European economy felt the pain of the Russian invasion of Ukraine pretty quickly. Oil, gas, food and fertilizer prices shot up at a time when Europe was still trying to recover from the impact of the COVID-19 pandemic. After three years, the European economy still feels the effects: Inflation is not yet back at target, the European gas price remains elevated enough to hurt industry, and monetary policy is still not at its long-run neutral level.

There are a number of different economic benefits to Europe that could accrue from peace in Ukraine. Russian gas flows might resume, which would ease conditions in European gas markets. European companies could be meaningfully involved in the reconstruction of Ukraine, and the re-integration of Russia with the global economy could lead to greater flows of trade and investment. Unfortunately, it feels premature to discuss any of this. Peace negotiations will not immediately lead to an upside for the economy because uncertainty around both the timeline and the outcome of the negotiations also makes any economic benefit uncertain. The rift between the EU and the U.S. is also obvious, which adds considerably to the uncertainty around outcomes.

The EU recently increased sanctions on Russia, and there is a willingness on the part of some EU members to sanction Russian gas. Even if the EU was willing to accept greater volumes of Russian gas, would the U.S., which wants to sell more liquefied natural gas to Europe, accept this situation? Europe may also find itself shut out of reconstruction plans, and elevated security concerns may even reduce investment flows into East European countries.

Europe had better get used to this new type of engagement with the U.S. More is on its way.

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