IN-DEPTH ANALYSIS

Requested by the ECON committee

Monetary Dialogue Papers, March 2025

European Parliament

Europe's policy options in the face of Trump's global economic reordering

Economic Governance and EMU Scrutiny Unit (EGOV)
Directorate-General for Economy, Transformation and Industry
PE 764.352 - March 2025

EN

***Acknowledgement**: The Authors would like to thank the European Macro Policy Network (EMPN) for bringing together a new generation of european macroeconomists from across the continent working to advance innovative economic policy recommendations.*

Europe's Policy Options in the Face of Trump's Global Economic Reordering

Abstract

In this paper, we propose and analyse four scenarios of a second Trump administration's economic policy and its impact on Europe, ranging all the way from moderate tariffs to full trade war, a full multilateral breakdown with the US leaving the IMF down to a more cooperative exchange rate realignment agreement. We assess two trade scenarios quantitatively and outline broader policy shocks and their economic consequences. Our findings highlight significant challenges for the ECB, requiring responses to trade disruptions, financial instability, and potential global economic reordering. We offer specific policy recommendations for the ECB to navigate these uncertainties.

This document was provided by the Economic Governance and EMU Scrutiny Unit at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 20 March 2025.

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LINGUISTIC VERSIONS
Original: EN

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Manuscript completed in March 2025

This document was prepared as part of a series on "US Shift to Protectionism: Impact on the Euro Area Economy", available on the internet at:
https://www.europarl.europa.eu/committees/en/econ/econ-policies/monetary-dialogue

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LIST OF ABBREVIATIONS

FX Policy	Foreign Exchange policy
USTR	United States Trade Representative
FRTP	Fair and Reciprocal Tariff Plan
VAT	Value added tax
WTO	World Trade Organisation
IMF	International Monetary Fund
NATO	North Atlantic Treaty Organisation
USAID	US Agency for International Development
AI	Artifical Intelligence
MAGA	Make America Great Again
PCCI	Persistent and Common Component of Inflation
TFEU	Treaty on the Functioning of the European Union
PBOC	People's Bank of China
OECD	Organisation for Economic Co-operation and Development
ECB	European Central Bank

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EXECUTIVE SUMMARY

- **The new Trump administration's approach aims for a radical global economic rebalancing**. Trump's first term focused on reducing bilateral trade deficits through targeted tariffs and trade deals. Treasury Secretary Scott Bessent and Council of Economic Advisors Chair Stephen Miran seek to eliminate global imbalances by driving down the dollar's value, lowering US bond yields, and boosting domestic industry. Tariffs are being used as a tool to pressure surplus countries – particularly China and the EU – to revalue their currencies and stimulate domestic demand.
- **The European Union (EU) is a likely target for aggressive US trade measures**. The Trump administration has already announced large reciprocal tariffs for April 2025. Reciprocal tariffs sound like an innocuous matching operation, but the plan would in fact give the US president unprecedent discretion to impose unlimited tariffs on any country which it deems as having policies, regulations or taxes the US disagrees with. These tariffs could be large and broad in scope, forcing the European Central Bank (ECB) to navigate their conflicting impact on growth and inflation. These measures may also set the stage for US pressure on the EU to loosen fiscal policy and allow the euro to appreciate in the context of a multilateral accord – inspired by the Plaza Accord – that would include exchange rate policy.
- **Quantitative analysis suggests sizeable economic impacts, and significant trade disruptions**. Model results indicate that US tariff increases under "low" or "high" reciprocal tariff schemes would reduce EU27 real wages by -0.25%, with Canada and Mexico facing larger losses. However, in a high reciprocal tariff scenario, EU27 exports to the US could decline by 17%, amplifying trade disruptions and having a significant macroeconomic impact.
- **But beyond trade, financial and exchange rate shocks may pose far greater challenges**. The Trump administration's economic strategy could escalate beyond trade into financial and monetary conflicts. Policies aimed at weakening the US dollar, pressuring surplus economies to revalue their currencies, or even withdrawing US support from key international financial institutions could create significant macroeconomic instability. These developments could trigger volatile capital flows, disorderly exchange rate adjustments, and heightened financial stress across global markets, with direct repercussions for the euro area.
- **As a result, of these shocks, the ECB and EU institutions may need to take on a larger role in safeguarding financial stability**. In extreme scenarios, a US retreat from multilateralism or the politicisation of dollar liquidity could force Europe to develop new financial defences. The ECB may need to expand swap and repo operations, strengthen financial backstops, and enhance coordination with fiscal authorities. Additionally, the EU could face pressure to deepen financial integration, reconsider exchange rate policy, and expand its role in international economic governance. Managing these challenges will require unprecedented coordination between the ECB, Europe's national finance ministries, and EU institutions to preserve economic stability and resilience.

1. INTRODUCTION

The ECB has started thinking about the consequences of geopolitical and trade fragmentation (ECB, 2025). The election of Donald Trump raises the prospect of more severe disruptions to global trade, international finance and the workings of the monetary system. One cannot say with certainty that there is a logic to Trump's trade policies: nobody had Mexico and Canada getting tariffed ahead of the EU on their bingo card - and yet that is what happened. Under Trump's first term (Trump I), the thinking, inspired by US Trade Representative (USTR) Robert Lighthizer and Trump advisor Peter Navarro, centred on US narrowing bilateral trade deficits with small bilateral tariffs. Now a more radical world view seems to have taken hold: Treasury Secretary Scott Bessent and Council of Economic Advisors Chair Stephen Miran (2024) have espoused a vision to correct global imbalances in demand and supply, trade, and exchange rate misalignments.

This shift in perspective is important because it opens the door to much higher tariffs than those levied under Trump I and spillovers into wider macroeconomic policies. The waters are muddied: the Miran-Bessent thesis is complemented with Trump's proclivity to use tariffs to replace income taxes as a source of revenue for the US government. For the ECB, the growing role of foreign exchange (FX) policy in economic disputes is crucial. So far, the US has focused on bilateral trade measures, but it may shift to FX policy on a multilateral scale. In the euro area, FX policy is set by European finance ministers (i.e., the ECOFIN Council) but can only be implemented by the ECB through interventions, provided they do not compromise its inflation mandate. This could intensify debates on global imbalances and reshape Europe's macroeconomic policy mix and coordination.

In this paper, we propose different scenarios of global trade and financial fragmentation and provide some stylized facts about their effects on the European economy.

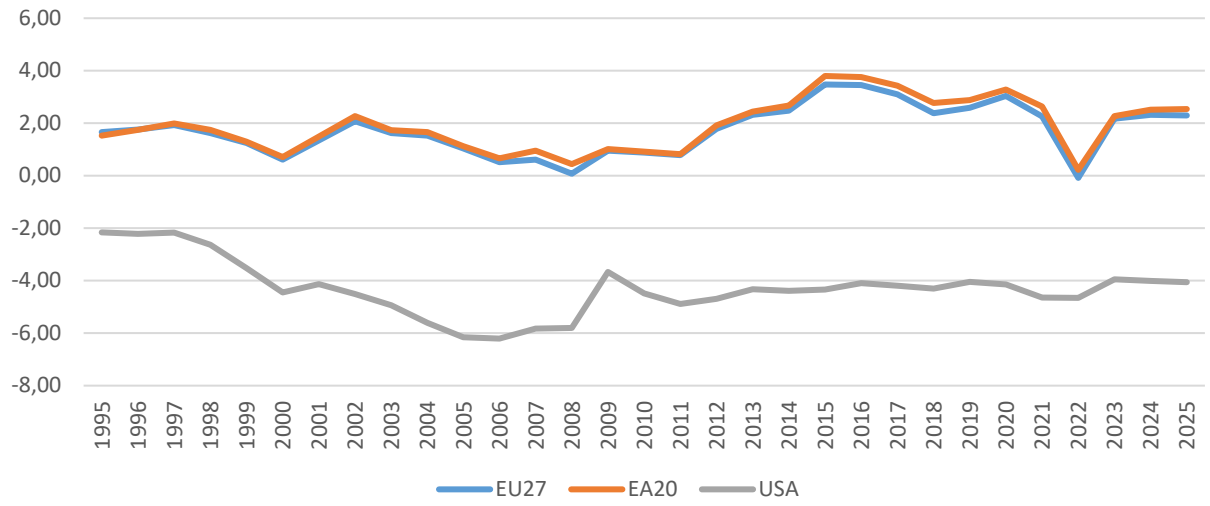
We discuss (i) the Trump measures taken already and a scenario of relatively benign tariff actions similar to that experienced under Trump I and (ii) a more aggressive set of tariffs to the tune of 20% for all European exports to the US, to which the EU would compelled to respond. We also outline a (iii) more dramatic scenario based on the far-reaching Trump reciprocal tariff plan leading to a full trade war and financial market turbulence. Finally, (iv) a more positive scenario where tariffs would eventually lead to a Plaza / Mar a Lago Accord with global FX realignment. This would lead to a significant appreciation of the EUR, the JPY and the RMB and a decline in the external value of the USD – helping to reduce the US' large trade deficit and Europe's surpluses.

We argue that these scenarios will introduce significant new challenges, potentially pushing the ECB to the limits of its current operational framework and instruments and may necessitate closer coordination with fiscal authorities.

2. US EXTERNAL IMBALANCES: THE GRAPES OF WRATH

The US trade deficit – together with the large government deficit of around 6% of its GDP – is a source of long-standing concern in the US. Consecutive US administrations have fretted about the pressure the import pull and lack of exports exerts on manufacturing, which now only represents 11% of US GDP and provides 13 million jobs. The depth and persistence of US external imbalances however drives an even larger part of the Trump administration's policy agenda: boosting industry in America, increasing energy production, constraining access of systemic rivals to key technologies and critical raw materials and reducing bilateral deficits.

Figure 1: Balances with the rest of the world in goods trade, national accounts, in % of GDP



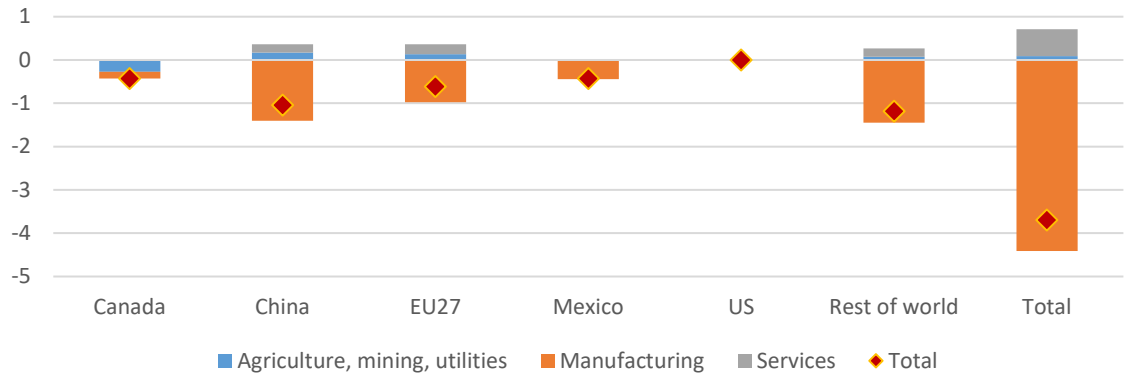
Source: AMECO

Since 2013, the US has maintained a goods trade deficit of around 4% of GDP, with a slight reduction during the pandemic (Figure 1). It runs deficits with nearly all major trading partners with a few exceptions, such as Australia and Brazil. As Figure 2 illustrates, the US trade deficit is most pronounced with China (1.04% of GDP), the rest of the world (1.18%), and the EU27 (0.61%). Interestingly, despite being targeted by Trump's trade policies, the US trade deficits with Canada and Mexico are lower at around 0.4%. However, the US offsets some of these deficits with services trade surpluses, particularly through its dominant tech and financial sectors.

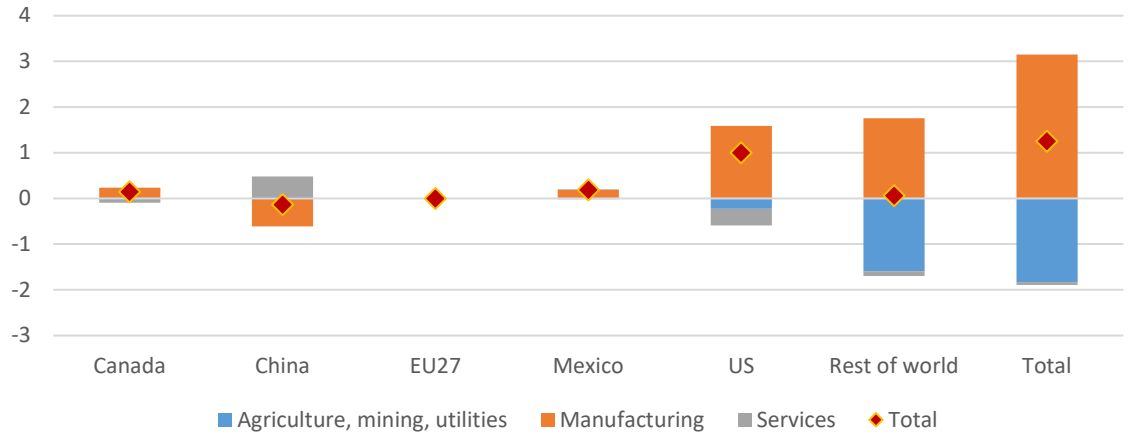
The EU shows large trade surpluses in manufacturing with the US (1.6%) and rest of the world but runs a strong trade deficit (1.59%) in agriculture, mining and utilities. The EU runs a deficit in services trade with the US. On balance, this results in an EU trade surplus of 1.5% of GDP and 1% against the US. China's overall trade surplus stems primarily from goods trade, but strong deficits in agriculture, mining and utilities and services.

Figure 2: Bilateral imbalances by broad industry categories, in % of GDP, 2022

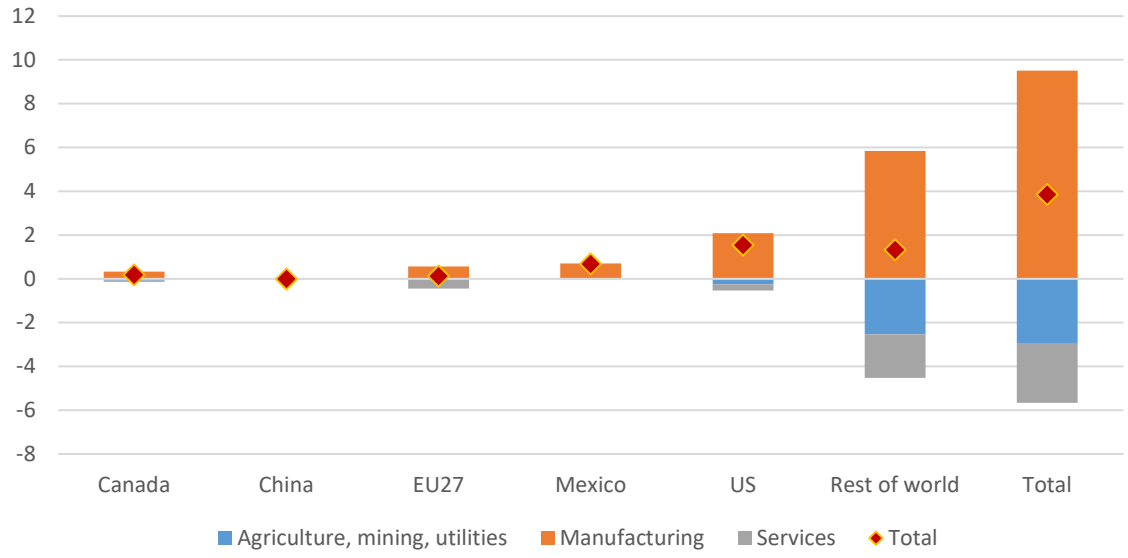
USA



European Union



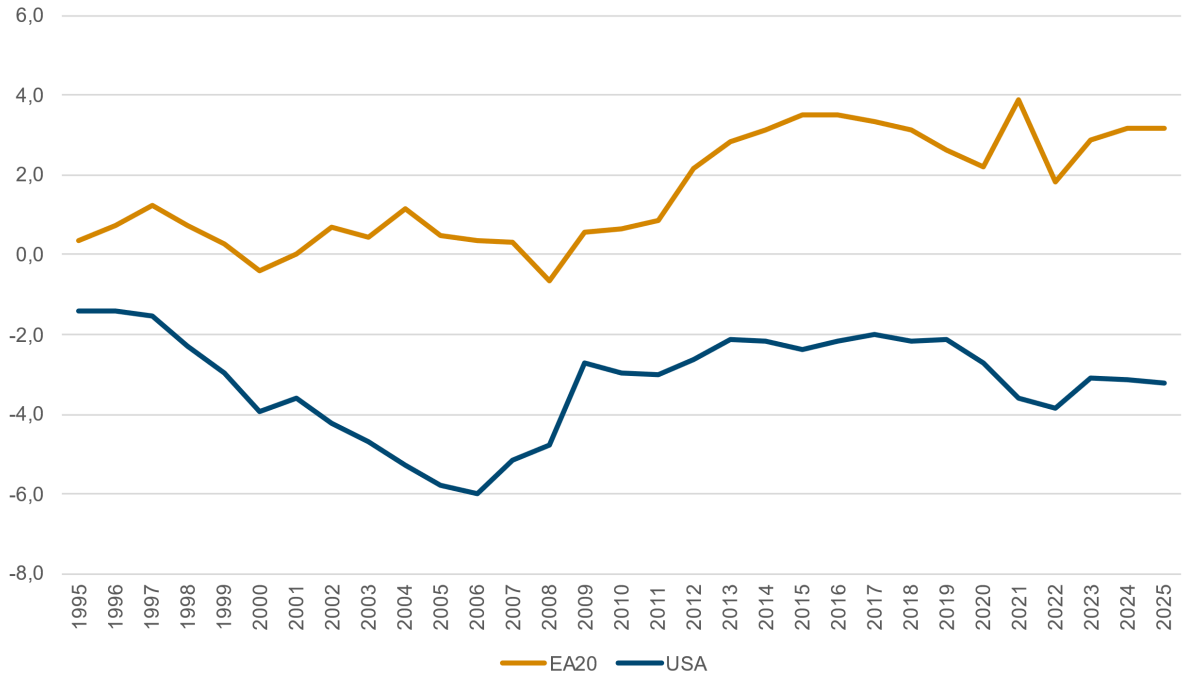
China



Source: Eurostat FIGARO, own calculations.

The US has a persistent current account deficit, requiring substantial foreign capital inflows. The current account balance reflects a country's net lending or borrowing position – surpluses indicate lending to the world, while deficits suggest reliance on foreign capital.[1] A net importer, like the US, borrows to finance imports, whereas a net exporter lends capital through trade surpluses. Figure 3 shows the evolution of US net borrowing: from 1.4% of GDP in 1995, it deteriorated to 6% in 2006 before falling to 2.1% in 2013 after the financial crisis, partly due to China's stimulus reducing global imbalances. The COVID-19 pandemic drove US net borrowing back up to 4% in 2020, stabilising at around 3% in 2024, where it is expected to remain in 2025. This means the US must attract capital inflows equivalent to 3-4% of its GDP annually to finance its deficit.

Figure 3: Net lending (+) and net borrowing (-) positions in % of GDP at current prices



Source: AMECO.

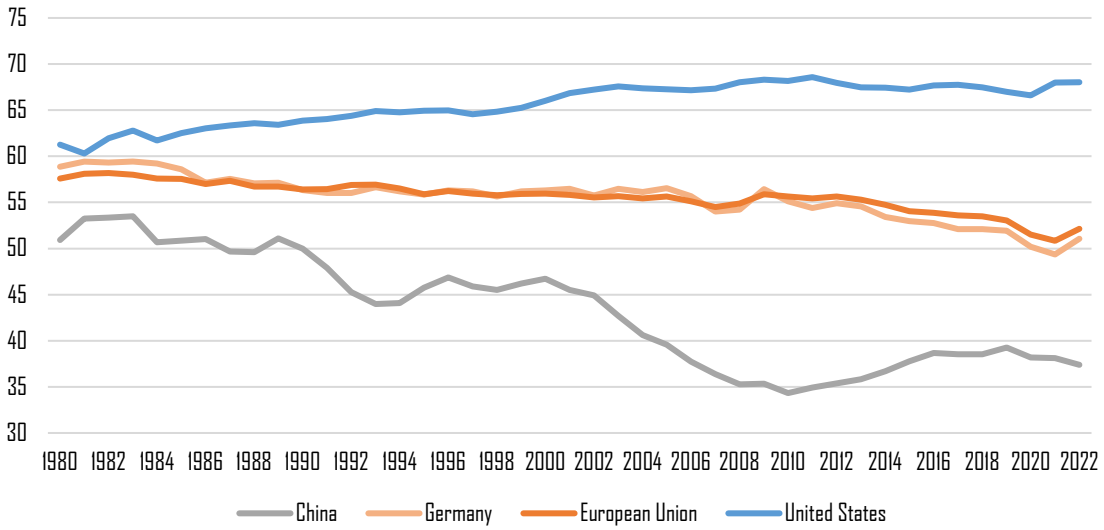
Unlike the US, the euro area and China are net lenders, not borrowers. The net lending position of the euro area started with a marginal 0.3% in 1995, but after the early 2010s European austerity drive, and the euro crisis, the EU economy became more dependent on external demand. After 2011 the net lending position started to increase to about 3.5% in 2016, from which it slightly decreased again. For 2024 and 2025, the net-lending position is slightly above 3%.

Structural differences in fiscal and consumption policies drive these imbalances. There are a number of factors that explain these structural deficits in the US and the corresponding surpluses on the part of trading partners. US consumers and businesses have a stronger demand for imports than foreign buyers have for US exports - in part because they have access to large quantities of credit finance (Mann, 1999). A persistently loose US fiscal policy also plays an important role in stoking domestic consumption. The euro area, for example, has run a consistently tighter fiscal policy than America. Former ECB President Mario Draghi (2024), for example, noted that from 2009 to 2019, the US government injected 14 times more into the economy: its primary deficits in absolute terms spending EUR 7.8 trillion compared to EUR

[1] According to National Accounts definitions, a trade deficit corresponds to a situation where domestic production (GDP) is lower than domestic overall consumption, whereas with a trade surplus the opposite is the case.

560 billion in the euro area (measured in 2023 euros. China, meanwhile, has focused most of its fiscal outlays on expanding domestic manufacturing capacity and real estate, not boosting household consumption. The US role as the 'consumer-of-last-resort' and China and Europe's relatively weaker consumption as illustrated in Figure 4.

Figure 4: Private consumption the US, EU and China, as a % of GDP



Notes: Households and NPISHs final consumption expenditure (% of GDP).
Source: World Bank

These factors can also be summarised by the US 'exorbitant privilege being the issuer of the most important global reserve currency. Since the dollar is the world's primary reserve currency and is widely used for global trade and as a reserve asset, demand for it is consistently high. This gives the US the ability to borrow at lower costs and run larger government and external deficits without facing the same financial constraints as other nations. Under this interpretation, the United States' *exorbitant privilege* allows financing easy deficit financing, something that the uses and abuses (Reinbold and Yi Wen, 2018)

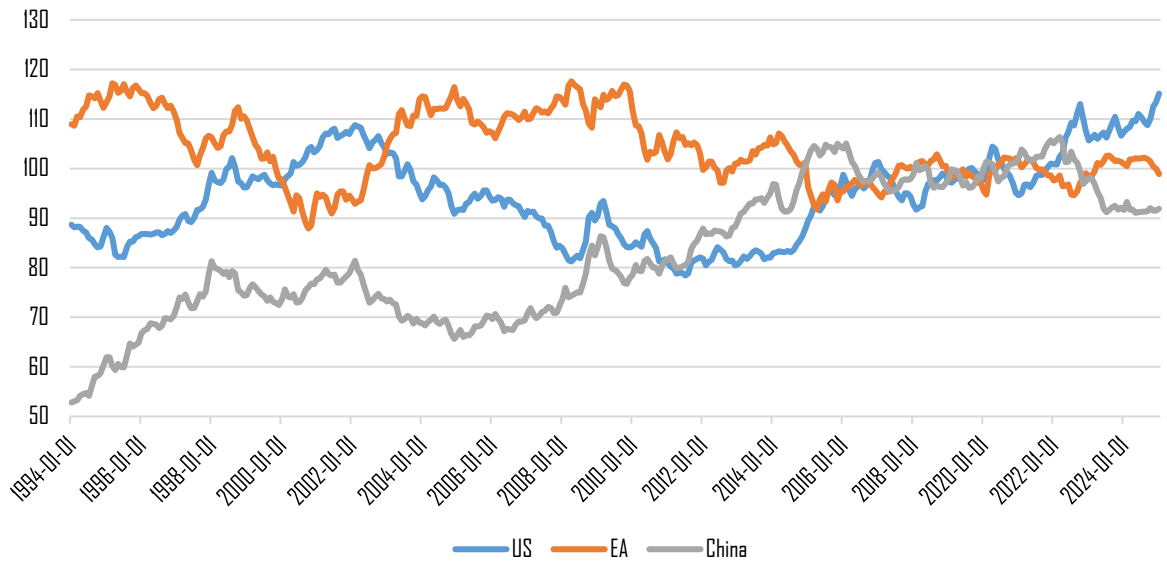
The Triffin dilemma highlights the risks of the US's structural exchange rate misalignment. The Miran-Bessent doctrine argues that the US dollar is persistently overvalued relative to its external competitiveness. In other words, if the US stopped running balance of payments deficits, global reserves would shrink, risking a global liquidity shortage that could trigger economic contraction and instability. This is the flipside of the exorbitant privilege, the great responsibility for global financial stability that "forces" the United States to issue more safe assets to the world than it would otherwise.

China plays a key role in sustaining US deficits through its export-driven growth model, alongside smaller roles for the euro area and Japan. Since the late 1980s, China's growth model has relied on chronically low domestic consumption and recycling the resulting savings glut into increasingly low-return investment. China's manufacturing exports exploded in the years following its World Trade Organisation (WTO) entry in 2001, turbo-charged by provincial governments who rolled out the red carpet for foreign firms looking to manufacture in China. An undervalued exchange rate, sustained by record intervention in the foreign exchange market, played its part too. Particularly after China clamped down on internal credit growth in 2004, it started to export far more manufactured goods than it imported. This rapid and asymmetric expansion of trade put pressure on manufacturing in the advanced

economies in what is now known as the 'first China shock' (Dizikes, 2021). The unbalanced Chinese growth model led to repeated pushes from the Bush, Obama, Trump and Biden administrations for China to revalue its currencies and lift domestic consumption (Sobel, 2023).

China's recent economic shifts have further amplified global trade imbalances. High savings is the flip side of low consumption, and after the global financial crisis, China's property sector absorbed a significant portion of the economy's excess savings to work at home. Exports had been shrinking as a share of China's economy between 2008 and 2018. But this has reversed in a big way (Setser et al., 2024). Since the property bubble burst in 2021, China's investment in the real estate sector is expected to be cut in roughly half while China has ramped up investment in priority manufacturing sectors, even as domestic demand for much of this output remains low (Hoyle and Jain-Chandra, 2024) .Chinese firms are increasingly trying to escape saturated and unprofitable home markets by going global, often with state support. The crackdown on China's property sector has therefore coincided with a large increase in China's trade surplus. China's manufacturing surplus is now a staggering 10 percent of its overall GDP – as noted by the New York Times (Bradsher, 2025).

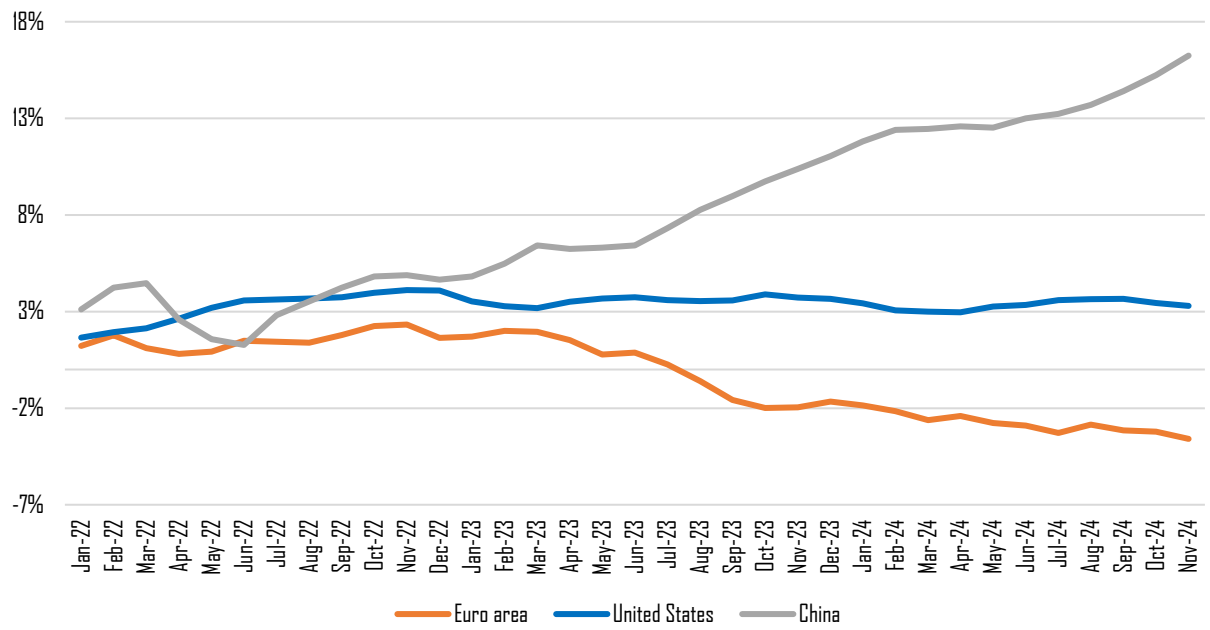
Figure 5: Real effective exchange rates, Index 2020=100



Source: Federal Reserve Bank of St. Louis (FRED).

The irony is that when it comes to China's growing imbalances, the US and euro area have now reversed roles versus the 2000s. Unlike the first shock when China's exports were focused on textiles and consumer electronics, the new China shock now affects sectors at the heart of Europe's economy - cars, chemicals, machines and planes (Tordoir and Setser, 2025). The result is that China's exports are growing at a staggering annual clip of over 10% a year, global trade at around 3%, whilst German euro area exports are languishing. As a result of the combination of the energy price shock of 2022 and China's growing competition, industrial production is not only declining in Germany, but in the euro area at large – whilst China's industrial production has exploded over the past years (see Figure 6). Both US exports and industrial production have held up better - probably reflecting in part that the US has a smaller - industry which is less export-dependent than that of the euro area. In fact, under President Biden, US demand provided an important offset for European firms losing ground in China and elsewhere as well as sluggish demand at home.

Figure 6: Industrial production in China, the US and the euro area (change in index's 3 month rolling-average versus 2021)



Source: calculations based on CPB World Trade Monitor, 2024.

The debate on the sources of global imbalances has three key implications.

- **First, the euro area has become increasingly reliant on US demand,** as China has pushed European imports out and undercut Europe in global export markets. The US now accounts for 16% of euro area exports, up from 12% in 2012. A similar trend is evident in services: in 2023, the US absorbed 22% of EU services exports, up from 18% in 2014 (Berg and Meyers, 2024). This leaves Europe exposed to Trump's tariffs, though not as much as Mexico or Canada.
- **Second, China's trade surplus now far outstrips those of Japan and Europe**. Over the past two years, its surplus in manufactured goods has surged. China, for instance, runs a manufacturing surplus six times the size of Germany's and reports a $1 trillion overall goods surplus in its customs data.
- **Third, in the long run, Europe's interest in seeing China boost domestic demand is increasingly aligned with that of the US**. An American administration bent on collaborating with allies would use these observations to coordinate pressure on China. Yet the Trump administration targets both friends and rivals in its tariff and trade war strategy.

3. THE TRUMP ADMINISTRATION'S ANNOUNCED AND EXPECTED TARIFFS

Trump's tariff strategy is a contradictory mix of economic coercion, reindustrialisation, and tax replacement. A genuine strategy for global rebalancing would aim to coordinate trade, fiscal, and exchange rate policies with the US's largest trading partners. Tariffs are framed as a tool to coerce countries into following Washington's lead, to re-industrialise America, and to replace income tax revenues. Yet, these tariffs -- we discuss the actual status of announcements in Section 4 -- will also harm US manufacturers, particularly carmakers, who depend on the cross-border flow of intermediate goods between these countries -- leading to a reversal on the part of the Trump administration. In this way, the use of tariffs as a coercive tool undermines the US's reindustrialisation efforts, at least in the short term.

The Trump administration has also signalled conflicting priorities on fiscal policy. To achieve global rebalancing, the US would need to reduce deficits and curb domestic demand, a goal at odds with the desire to extend and expand tax cuts. A third area of tension, which has yet to fully emerge, is exchange rate policy. Treasury Secretary Scott Bessent has proposed using tariffs to "escalate to de-escalate," aiming to pressure the euro area to revalue the euro, and China and Japan to revalue the renminbi and yen -- all while simultaneously pushing for increased consumption in these regions (Financial Times, 2024).

To understand the euro area and challenges for the ECB, and insofar as there is any logic to the Trump administration's policies, it's useful to view unfolding events as a possible staged politicisation of these instruments. **Tariffs will be the first and most widely deployed weapon. Fiscal and exchange rate policies would follow**. For now, tariffs and trade are the main locus of action. The Trump administration has already announced a flurry of tariffs and investigations of trading partners' practices that would lead to tariffs. But it is useful to first consider the baseline.

Following decades of trade liberalisation, tariffs between the US and the EU are currently quite low. Table 1 lists the bilateral tariffs mutually faced by major trading partners focusing on the EU, the US and China. For non-agricultural products, the EU faces average tariffs when exporting to the US of 3.9%, whereas the US exporters face 4.5% when shipping their products to the EU. Before the latest bout of US tariffs on China, the country faced duties of exporting to the US of 4.0%, whereas US exporters shipping to China faced 6.0%. The conclusion is clear: US import tariffs are marginally smaller for non-agricultural products, but the differences were merely 0.6% in case of the EU and 2% in case of China. The tariffs as well as differences between the US, EU and China are larger for agricultural products.

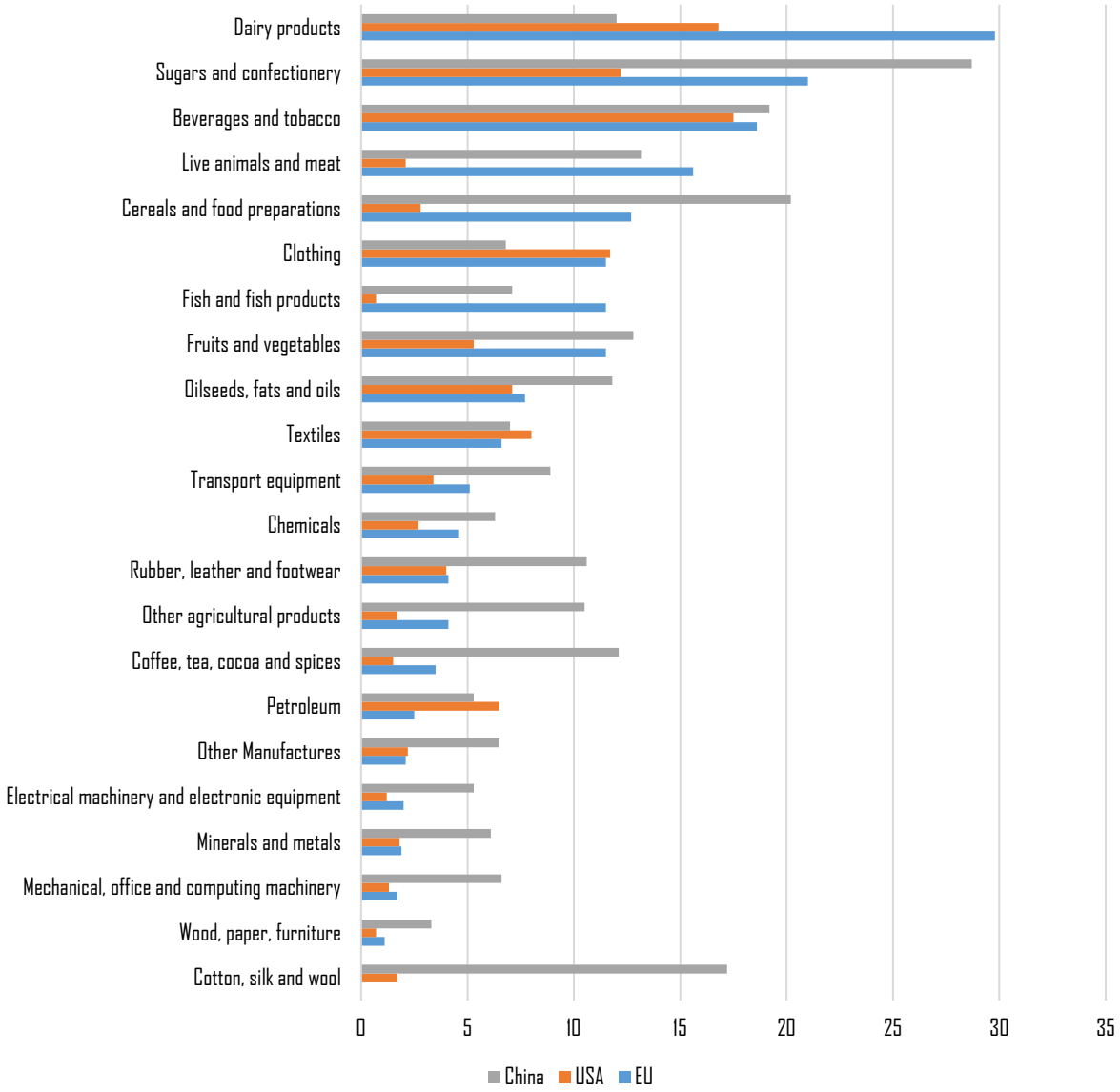
Table 1: Bilateral duties faced by major trading partners in %, 2022

European Union duties faced		US duties faced		China duties faced	
Agricultural products					
United Kingdom	14.2	China	12.2	European Union	13.8
USA	7.5	Canada	21.3	Japan	13.9
China	12.5	Mexico	14.8	Hong Kong, China	0.0
Switzerland	32.1	Japan	20.1	USA	4.8
Japan	20.4	European Union	14.7	Korea, Republic of	63.6
Non-agricultural products					
USA	3.9	European Union	4.5	European Union	4.5
United Kingdom	3.5	Canada	2.5	USA	4.0
China	6.1	Mexico	5.6	Hong Kong, China	0.0
Switzerland	1.3	China	6.0	Japan	3.2
Türkiye	4.8	United Kingdom	3.0	Korea, Republic of	6.1

Source: WTO Tariff profiles, 2024.

A similar pattern can be seen when considering tariff profiles by more detailed product groups (see Figure 7). Tariffs are on average larger for agricultural products with the EU generally imposing larger tariffs on imports compared to the US. For non-agricultural products, the US imposes slightly higher tariffs in textiles and clothing, whereas the EU imposes larger tariffs in transport equipment (5.1% compared to 3.4%), chemical products (4.6% compared to 2.7%), and electrical machinery and electronic equipment (2% compared to 1.7%). China charges the highest tariffs for most product categories of transport equipment (8.9%), rubber, leather and footwear (10.6%), electrical machinery and electronic equipment (5.3%), mechanical, office and computing machinery (6.6%).

Figure 7: Mutual tariffs by product group, 2022, in %.



Source: WTO Tariff profiles, 2024.

The Trump administration has already announced a range of trade measures. However, many of these actions remain speculative and are subject to change, with potential delays or adjustments depending on the outcome of ongoing negotiations and policy decisions. Trump imposed a 25% tariff on Mexican and Canadian goods on Tuesday 4 March, announced an exemption for the auto industry on Wednesday 5 March, then on Thursday 6 March delayed the taxes until April 2 for products traded under the United States-Mexico-Canada Agreement. Later in the month, 25% global tariffs on steel and aluminium are expected to be implemented, with no country or product exclusions so far. The administration may also launch new trade investigations under Section 301, which targets unfair trade practices, and Section 232, which addresses national security concerns – both are sectoral but broadly impactful tools that can significantly affect trade dynamics and economic outcomes. For instance, the US might investigate the EU's digital services taxes it deems unfair to American tech firms, potentially leading to retaliatory tariffs on unrelated EU products like German cars. Later in the year, the administration may act on the America First Investment Policy Memo, possibly tightening restrictions on US investment in China.

Most importantly, on 13 February, the Trump administration unveiled the Fair and Reciprocal Tariff Plan (FRTP). Of all Trump's trade proposals, this is by far the most consequential — and potentially the most damaging.[2] At first glance, the FRTP appears to be a simple tariff-matching exercise, in which the US would align its import tariffs with those imposed on its exports by trading partners. Given the sheer number of products and trade relationships involved, this approach would result in an unmanageable patchwork of different tariff rates. Even if such a system could be implemented, Europe would face relatively minor consequences since EU tariffs on US imports are only slightly higher than US tariffs on EU imports. In reality, the FRTP is much more radical than a mere matching exercise and would open up a way to a more dramatic breakdown in the trade system. In particular, President Trump has explicitly mentioned considering Europe's VAT system as a non-tariff barrier against which the US would want to respond. This could potentially pave the way for the United States to introduce as much as 20% of new tariff on all European goods. Such a measure, falling under the FRTP would mark a considerable escalation but would be in keeping with measures introduced against Canada and Mexico. One should therefore take them very seriously.

[2] For an excellent expose on this plan and what it means for Europe see Berg (2025).

4. SCENARIOS OF TRUMP-INDUCED GLOBAL TRADE FRAGMENTATION

In this section, we try to ascertain the potential path for US trade and financial policy and how they might reset the international macroeconomic framework.

We thus propose the following four scenarios:

- **Scenario A**: Already announced tariff increases, plus a low reciprocal tariff that escalate into higher tariffs, but escalations remain contained.
- **Scenario B**: High reciprocal tariffs that include VAT by the US. WTO-conform retaliation by the EU.
- **Scenario C**: High reciprocal tariffs and full trade war escalation with no equilibrium leading to US withdrawing from Bretton Woods institutions and financial sanctions/ fragmentation.
- **Scenario D**: Plaza / Mar A Lago accord following high tariffs and coordinated FX/Macro settlement

On the basis of announced US policies, and the ones in the works, we draw out scenarios that may play out based. They combine trade and tariff action, but also through a broader range of policy tools that the US could use against the EU.

Scenario A: Low reciprocal tariffs

First, we define a **basic trade war scenario** that includes these already announced tariff increases:

- The US imposes a tariff of **25% on steel and aluminium products** on all countries.
- Products from **Canada and Mexico are subject to a 25% tariff**, Canadian energy products will be charged a reduced rate of 10%. Canada announced it will retaliate by charging 25% on imports from the US (from 4. March onwards on products worth $30 billion, from 21. March products worth $155 billion): for simplicity, we model a 25% tariff on all goods from the US. On 6. March, President Trump backtracked on a 25% tariff on Mexico and Canada: Products that fall under the USMCA agreement can cross the border tariff-free. However, the full 25% tariff are scheduled to be enacted in one month, so we include them in our scenario.
- We further include the **additional 20% tariffs on China**.
- **Chinese retaliation** tariffs (mining products from the US will be charged a 15% tariff, while the tariffs on machinery, vehicles and transport equipment will be increased to 10%. After the last 10% tariff increase on Chinese goods, China furthermore announced tariffs of 15% on agricultural goods) are also included here.

Additionally, this "low" intensity trade war scenario includes a weak form of reciprocal tariffs: we suppose the US simply mirrors the tariffs of a partner country, if these tariffs are higher. If the US tariffs are already higher, the US will keep their higher tariff. We do not assume that the US will lower tariffs, and we do not assume the EU will respond with aggressive countermeasures.

Scenario B: High reciprocal tariffs

Next, **a "high" intensity trade war scenario** is defined on the basis of reciprocal tariffs where the US **includes Value-Added Taxes** in their calculations of their "appropriate" mirror tariffs. Instead of setting product-specific tariffs to match those of other countries, the US would impose an overall additional tariff rate on each trading partner. This rate would not only reflect tariffs levied on US exports but also a range of other factors, including domestic taxes deemed discriminatory (such as Value-Added Tax, VAT), non-tariff barriers like subsidies and regulatory requirements, exchange rate policies, and any

other measure that Washington sees as distorting competition. The scope of these measures is extraordinarily broad, amounting to an attempt to dictate how other countries regulate their economies and raise revenue.

A contentious element of the plan is Trump's claim that VAT functions as a trade barrier. VAT is a standard tax used by countless countries to finance public services, but the US does not have one, relying instead on a sales tax system that varies by state. Economically, VAT is trade-neutral: it applies equally to domestic and imported goods, with border adjustments ensuring that it is levied only on domestic consumption. However, the Trump administration argues that VAT, with its border adjustments, acts as a tariff. This claim is baseless, but if the US were to treat VAT as a trade distortion, it would disproportionately affect Europe, where VAT rates typically range from 19 to 21 per cent and up to 27 per cent in Hungary.

The EU is also vulnerable to US tariffs targeting non-tariff barriers and regulatory policies. Washington has long objected to EU regulations such as sanitary and phytosanitary standards and the General Data Protection Regulation (GDPR), but the FRTP expands the scope of US complaints to include newer rules like the Artificial Intelligence (AI) Act, the Digital Markets Act, the Digital Services Act and the Corporate Sustainability Reporting Directive (CSRD). Since all of these impose compliance costs on businesses — including US firms operating in Europe — the Trump administration could use them as a justification for tariffs. In effect, any EU regulation affecting businesses could become a target.

For simplicity, we **assume that all tariffs against EU27 countries are additionally increased by 20 percentage points**, on top of the reciprocal tariffs from the low intensity trade war scenario above. For the moment, we do not assume and model such a VAT compensation for other countries except the EU27 (as the EU27 seems to be the main target for reciprocal tariffs). As for EU27 retaliation, we assume in this scenario that the EU would hit back with their own "reciprocal" tariffs: according to the WTO, a country can impose tariffs such that it is fully compensated (in terms of euros gained from tariff revenues). Given the already lower trade flows at that point, **we assume the EU implements an additional 30 percentage points tariff increase on all US goods** to make up for the losses incurred by the US tariffs.

Services are not subject to tariffs. As stated above, we employ short-time elasticities for this model estimation. It is important to note that this does not translate to a time interval over which these effects would take place. With the model we can compare the "real" economy in 2020 with a hypothetical economy of 2020 where these trade policy changes are already in effect.

Scenario C: Armageddon: aggressive trade and financial policy action

President Trump has announced new reciprocal tariffs on April 2nd. On 1 April, the US Trade Representative, the Department of Commerce, and other agencies will publish their findings, after which they will submit joint policy recommendations to the president. By July, the Office of Management and Budget is expected to provide its own evaluation. Given the vague methodology of the reciprocal tariffs, which lacks a clear mechanism to translate its five factors into a single tariff rate per country, the actual tariff levels will ultimately be at the president's discretion. The EU has an opportunity to prepare and attempt to steer Trump away from the most aggressive measures and to prepare a bold list of countermeasures.

If Trump follows through on his threats regarding VAT, he could justify tariffs of at least 20 per cent on EU goods alone. Such a move would lead to an estimated $200 billion annual drop in EU exports to the US - equivalent to one-third of current EU goods exports to America, or about 1 per cent of EU GDP (Berg, 2025). The appreciation of the dollar and the exclusion of services from tariffs would partially

offset this, narrowing the net loss to around $166 billion. However, if the FRTP also penalises regulatory barriers, the tariffs — and the economic fallout — could be even more severe. If the US applied similar measures to all its trading partners, the global impact could be even worse than Trump's campaign pledge of a 20 per cent general tariff and a 60 per cent tariff on China. US tariff levels would soar to their highest point since the Great Depression, fuelling inflation domestically while a stronger dollar would erode US export competitiveness. The countermeasures could lead to a completely anti-cooperative outcome where the US would not only announce its withdrawal from the WTO, which for all intents and purposes it has already left, but also of the United Nations, the World Bank and the International Monetary Fund (IMF), in keeping what is already happening domestically with gutting US agency for international development (USAID).

All this would have profound consequences on the operation of the dollar system, on capital flows globally and would most probably create a massive tightening of global financial and liquidity conditions that would compound the effects of the aggressive tariffs policy.

Scenario D: A Mar a Lago / Plaza Accord and coordinated global rebalancing

A stand-alone aggressive trade policy against China and US allies is unlikely to achieve global rebalancing but could ultimately pave the way for a broader economic settlement — a strategy Bessent has described as "escalate to de-escalate" to achieve a "grand economic reordering". If implemented as envisioned by Trump, tariffs would instead have only a limited effect on the trade deficit but would come at a significant cost to the global economy. Retaliatory measures, combined with a possible Chinese devaluation of the renminbi, would push the dollar higher (although its safe haven status has been wobbling of late), exacerbating global financial instability. Bessent and Miran may understand the disruptive potential of the Make-America-Great-Again (MAGA) economic agenda - not only for the US and the dollar's global role but for the world economy as a whole.

Bessent-Miran's preferred outcome seems to be a managed "global economic reordering" - which would likely take the form of an international grand bargain. Just as Trump negotiated a bilateral trade deal with China in his first term, the US could seek a coordinated, gradual depreciation of the dollar in exchange for lowering its tariffs. This would compel China to allow greater currency flexibility while enabling other major economies to contribute more to global rebalancing by stimulating domestic demand. The euro area and Japan would play a role in this too, using fiscal expansion and currency appreciation to take on more of the burden of global demand growth. This would reduce their reliance on exports and help ease global trade imbalances.

In return, the US would commit to tariff reductions and some degree of fiscal consolidation. Such a framework would facilitate a better allocation of global savings and investment, ultimately supporting stronger growth, particularly in emerging markets. This approach echoes the 1985 Plaza Accord, in which the US coordinated a controlled weakening of the dollar. A similar cooperative strategy could integrate MAGA economic policy into an international framework, preventing destabilising dollar surges and the risk of unsustainable fiscal expansion leading to debt monetisation and a currency crisis.

This scenario, in essence, is the benign reading of the Bessent-Miran's plan where aggressive trade policy is simply used to bring other countries to the negotiating table. But trade policy alone is not designed to achieve the global rebalancing, which would rather be achieved through macroeconomic policies and exchange rates realignments by way of an international economic policy coordination framework.

However, the Bessent-Miran's plan faces significant hurdles. They must first establish coherence within the Trump administration's economic policymaking. Then, they would need to craft a credible fiscal consolidation strategy that could pass through the Congress. Most critically, they must restore the US

government's ability to coordinate economic policy internationally without which, the risks of disorderly adjustments, financial instability, and economic fragmentation will grow. For the EU and the ECB, coming to the negotiating table for such a grand bargain would be difficult and would raise important economic policy coordination challenges.

4.1. Quantitative evaluation

After discussing the radical scenarios, in this section we focus on already announced tariff hikes and model their impact on welfare and real incomes in the US and its main trading partners Mexico and Canada as well as the EU and its Member States. We employ the model outlined in Caliendo and Parro (2015) which, in essence, is a Ricardian trade model[3]. Its main equation relating trade flows to characteristics of the exporting and importing countries mimics a structural gravity equation[4]. However, contrary to structural gravity models (such as described in Yotov et al. (2016) and Grübler and Reiter (2021), the Caliendo and Parro model does include input-output linkages. This means that an increase in exports of a certain good will also increase the flows of its intermediate inputs which may again be international trade flows. As a result, with this model we can specifically examine the effects of trade policy changes on global value chains – a capability not possible with structural gravity models. For instance, see Mendoza et al. (2024) for a recent application of the model to the EU carbon border tax issue.

The model is based on Organisation for Economic Co-operation and Development (OECD) inter-country input-output database, see OECD (2023). It covers 77 countries and 45 industries. This database includes data for nearly all model variables, such as international trade flows, input-output coefficients, shares in final demand and so forth. Furthermore, we use estimated trade elasticities from Fontagné et al. (2022) and Eppinger et al. (2023) for the goods-producing industries while the elasticities for the service sectors are taken from Freeman et al. (2021). These elasticities are computed for the long-term. Since we are interested in the short-term, we divide them all by four, as proposed in Baqaee et al. (2024). Finally, trade data is collected from the WITS platform of World Bank (2023) and has been cleaned and used in Cieślik and Ghodsi (2024). We use data from the year 2020, which is the latest year for which all data sources are available.

4.2. Results

Figure 8 shows the estimated impact of the two possible scenarios described above (Scenario A and B) for welfare and real wages. Welfare refers to real GDP here. Please note that the high reciprocal tariff scenario B includes the low reciprocal tariffs A (i.e., the additional 20% tariffs on the EU27 for the alleged VAT compensation are added on top of the steel and aluminium and the low reciprocal tariffs).

We can see that the low intensity trade war scenario A has quite diminished impacts on the EU27. The overall effects of scenario A is estimated to have a still small impact at -0.014%, due to the fact that (a) the steel and aluminium tariffs only affect one industry, thus their effect on total GDP remains marginal, and (b) tariffs of the EU27 are – on average – a little higher than the tariffs of the US, but the absolute

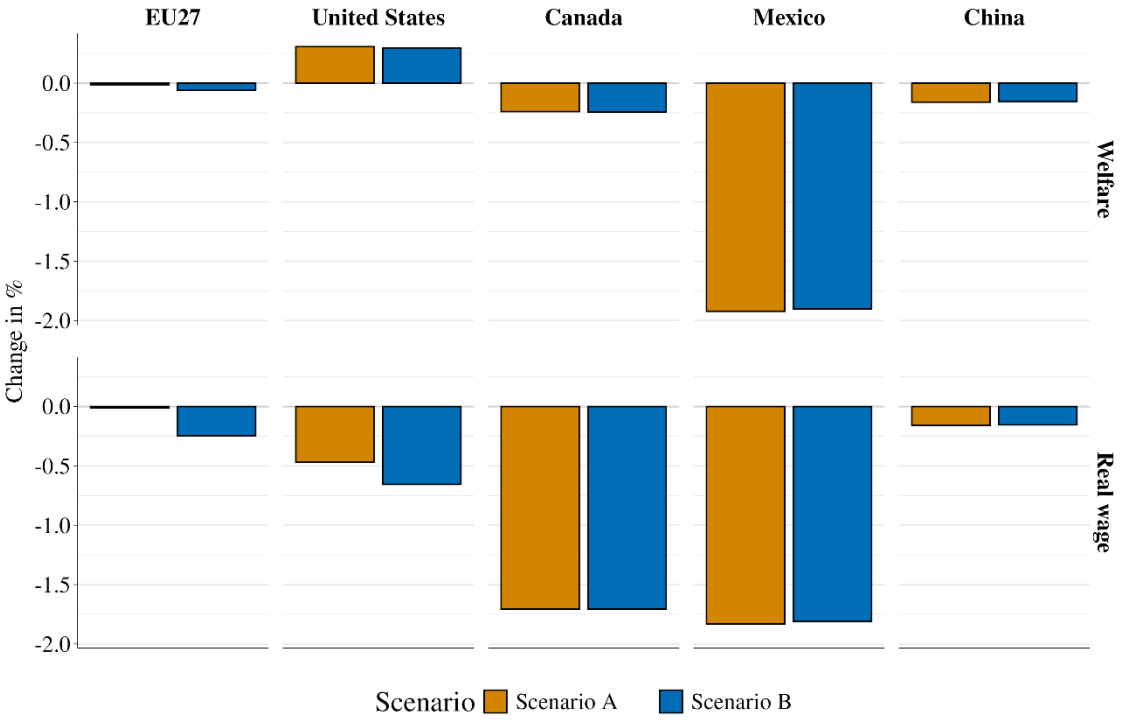
3 A Ricardian trade model is based on several key assumptions: (i) fixed endowments of production factors (typically labour), (ii) constant labour productivity within each country but differing across countries due to technological differences, (iii) perfect competition in goods and labour markets, and (iv) specialization based on comparative advantage, where each country exports the good in which it has a relative productivity advantage.

4 The structural gravity equation states that trade flows between two countries are proportional their economic size and inverse proportional to the geographical distance between them.

difference is not large and for some industries the US has the higher tariffs (and thus tariffs would not increase for these industries in this scenario).

The high reciprocal tariffs scenario B, however, does produce larger changes in the welfare of countries: Welfare of the EU27 is expected to decrease by 0.06% in this case. The decrease in real wages is with 0.25% a little bigger and is a mixture of reduced exports to the US and increased import prices due to the retaliatory tariffs of the EU on the US.

Figure 8: Changes in welfare and real wages by scenario, in %



Source: Authors' own calculations.

The fact that we see welfare increases for the US (about 0.3% in both scenarios) can be attributed to the fact that the model assumes that all tariff revenues are directly transferred to households (thus increasing their incomes). Since this is unlikely to hold in reality, we additionally look at the impacts on real wages, where we see that they decrease with tariff increases: as imports become more expensive for the US consumers, their real wages are reduced.

The effects for Canada and Mexico are at higher magnitudes and show a slightly different pattern compared to the EU27: They lose the most when the low reciprocal tariffs from scenario A are enacted (which includes the announced 25% tariffs on Canada and Mexico). However, when additionally, the high reciprocal tariffs from scenario B are implemented by the US, their welfare losses would decrease a bit. The reason is that when the US charges reciprocal tariffs from all other countries, some imports from Canada and Mexico become competitive again and exports to the US slightly increase, causing a slight increase in welfare.

The far higher effects for Mexico (around –1.9%) compared to Canada (-0.24%) come, first, from a much higher export dependence of Mexico on US demand and secondly from the fact that we have not included Mexican retaliation as of now.

China, even though it is directly affected by the steel and aluminium tariffs, sees only marginal welfare changes of about -0.15% in any of the three scenarios.

We turn our attention now to changes in trade flows and look in more detail what impacts tariff increases of President Trump would have on trade flows.

Table 2: Changes on trade flows in Scenario A

	Importer					
Exporter	**EU27**	**United States**	**Canada**	**Mexico**	**China**	**Other**
EU27	0.0	4.3	0.8	-11.8	-2.8	-0.4
United States	-3.3	2.4	-28.3	-15.6	-8.2	-4.1
Canada	1.2	-21.6	-0.9	-13.1	-2.1	-0.1
Mexico	8.4	-24.6	11.8	-5.5	6.4	7.3
China	1.3	-21.7	1.4	-11.0	-1.2	0.7
Other	0.3	1.5	1.4	-12.0	-2.4	-0.2

Source: Authors' own calculations.

In the low reciprocal tariffs scenario (table 2), exports of the EU27 to the US will actually increase by about 4.3%: this is due to a partial redirection of US imports from Canada, Mexico and China to the EU27. Exports of the EU27 to Mexico and China will decrease by 11.8% and 2.8% respectively. Imports from those two countries (and Canada) will, however, increase by 8.4% and 1.3% (and 1.2%): due to the tariffs levied on them by the US, exporting firms will reduce their prices a bit and thus also becoming more attractive and competitive for the EU27 Member States, who will increase their purchases from those three countries.

Table 3: Changes on trade flows in Scenario B

	Importer					
Exporter	**EU27**	**United States**	**Canada**	**Mexico**	**China**	**Other**
EU27	-0.1	-17.4	1.2	-11.3	-2.4	-0.0
United States	-18.0	2.6	-28.2	-15.4	-8.1	-4.0
Canada	1.1	-21.4	-0.8	-12.8	-1.9	-0.0
Mexico	8.6	-24.2	12.0	-5.3	6.4	7.3
China	1.3	-21.3	1.5	-10.7	-1.1	0.8
Other	0.4	2.1	1.5	-11.7	-2.3	-0.2

Table 3 displays the expected changes in trade flows if the high reciprocal tariffs were to be implemented: With such high tariffs, exports from the EU27 to the United States would drop by an estimated 17%, while exports to Canada would increase by 1.2%. Exports of the EU to Mexico would decrease by 11.3% and to China by 2.4%. Overall, total EU27 exports would decrease by almost 2.9% (not counting trade flows within the EU27). The overall decrease in exports would also carry over to the

EU common market: Intra-flows of the EU27 could decrease by 0.1%, a consequence of the lower exports and higher prices of imports. The US would source some of its previous imports now from itself (increase by 2.6%): Imports from *all* other countries would decrease.

5. POLICY OPTIONS AND CHALLENGES FOR THE EU AND ECB

The scenarios we offer suggest three distinct sets of policy challenges. The mild trade spats - up to and including high reciprocal tariffs - can be addressed within existing monetary frameworks even though they will certainly complicate the ECB's current approach by creating upside risks to inflation and downside risks to growth, which will require careful calibration of the policy response and detailed understanding of the persistent nature of the external inflationary shocks. The more extreme scenarios – a trade Armageddon (Scenario C) or virtuous global rebalancing (Scenario D) – will require a broader rethink of the ECB's policy tools and interactions with the other EU institutions.

5.1. Tariffs and domestic prices: a monetary policy challenge

Trump's trade policies will create a dual shock for the EU: higher inflation and lower growth. The extent to which exchange rate adjustments will cushion these shocks remains uncertain. However, the policy uncertainty may already be undermining business confidence and investment, weighing on economic growth. Insofar as euro area inflation keeps declining, the ECB has the policy space to respond to these shocks, but they will raise important policy challenges. In particular, there is an ongoing and unsettled discussion at the Governing Council about the level of the neutral rate and therefore about the extent to which policy is easing / restrictive and this ought to be more complicated in the face of external price shock and negative activity shock (Schnabel, 2025).

An important part of the economic policy response will also lie with fiscal policy and the ongoing discussions about a common borrowing capacity at the European level to finance greater defence spending. The Commission is loosening the EU fiscal rules and making EUR 150 billion available in loans to member-states for defence spending. Germany's looming debt brake reform and significant fiscal loosening - with a EUR 500 billion - infrastructure fund over ten years and significantly higher defence spending - is also important for the ECB. This ought to add both upward pressures to growth and inflation to weighed against the drag coming from the negative external and confidence shock. In particular, were the ECB continue to seek to ease policy, these developments ought to affect the ongoing discussions around the adequate size of the ECB's balance sheet and the speed at which the ECB should converge towards its optimal/structural balance sheet. Indeed, in the current environment the ECB's reduction / normalisation of the size of its balance sheet has an important effect on the term premium, the shape of the European yield curve and the monetary and credit impulse. Given the prevailing uncertainty, the ECB should consider a slower pace of balance sheet reduction so as to enable fiscal policy to play its full role and should consider the extent to which cutting rates while reducing the size of its balance sheet may undermine the impulse of its policy.

The ECB's monetary framework must evolve to address external economic shocks more proactively. The past few years, the ECB's monetary policy was largely backward-looking to measure the persistence of the energy price shock stemming from Russia's invasion of Ukraine. To tackle this challenge, the ECB (2023) has developed three criteria to assess how this shock is transmitting through the economy: 1) evaluating the implications of incoming data on inflation forecasts, 2) analysing underlying inflation trends using measures like the Persistent and Common Component of Inflation (PCCI), and 3) assessing the strength of monetary policy transmission, particularly during the shift to higher interest rates. This framework is also useful for managing the effects of Trump's trade war, which introduces complex inflation risks. For example, the US' 20% tariffs on China could push deflationary Chinese goods into European markets, lowering inflation, unless the EU retaliates, which could drive inflation up again. The ECB does not target the exchange rate but will take the knock-on effects of exchange rate movements into account in its macroeconomic projections.

While the ECB's broad decision-making framework since March 2023 based on three criteria to guide its monetary decisions amid high inflation and uncertainty is still useful to reduce uncertainty but is too backward-looking. Indeed, the ECB has to adopt a more forward-looking framework about the expected effect of the external economic shock to the inflation and growth path. It must also elevate its assessment of the strength of monetary policy transmission in an environment of possibly heightened exchange rate and financial market volatility. The broader implication is that the ECB's uncertainty-management framework also applies to Trump's trade war and may require the ECB to communicate more about its policy assessment, including possibly via a more explicit communication of each Member of the Governing Council's assessment of the central path for the inflation and policy outlook (Vallee and Tordoir, 2022).

The higher incidence of supply shocks and elevated uncertainty should also inform the ECB's strategy review due in the summer of 2025. This includes, for example, energy shocks, sudden contractions of trade, climate contingencies, as well as exchange rate volatility from Trump's policies. Scenario planning could become an even more important feature of the ECB's modelling and forecasting, to account for the large uncertainty on the inflation and growth outlook. Furthermore, a review of instruments over the full cycle seems advisable: the use of forward guidance, for example, should be flanked with escape clauses in case the distribution of shocks turns out differently than anticipated. In general, the instrument should arguably not lock the ECB in too long. Finally, the ECB could consider being a bit more relaxed about small over and undershoots around the 2% inflation target to avoid fine-tuning demand management in the presence of frequent supply shocks.

5.2. International economic policy coordination and exchange rate policy in Europe

In our Scenario D where the ongoing trade war would morph into a cooperative discussion on global macroeconomic adjustment, there would be a need for the EU to arrange a coordinated position between the fiscal and monetary authorities on the necessary macroeconomic adjustment and ideal policy mix. This could also culminate in a possible agreement for a new exchange rate policy from the euro area potentially leading up to coordinated FX interventions.

This would push the ECB into a fairly novel situation even though there has been FX interventions by the ECB in the past on at least three occasions. In September 2000, the ECB conducted a first coordinated FX intervention to strengthen the Euro, which had fallen to 0.85 vs the USD. This was followed by another unilateral intervention in November 2000. In 2011, following the Fukushima nuclear melt-down incident in Japan and the rapid and disorderly appreciation of the Yen, the ECB along with the Federal Reserve and G7 Central Banks participated in coordinated FX interventions to weaken the yen. In 2022, the ECB proceeded to verbal interventions when EUR-USD fell sharply following the war in Ukraine and the ensuing energy crisis.

Interestingly, however, FX policy is in principle the purview of the ECOFIN Council which sets the guidelines for external FX policy pursuant to article 219 of the Treaty on the Functioning of the EU (TFEU). Historically, FX interventions have been solely decided by the ECB. In the context of an international agreement inspired by the Plaza Accord, the negotiation and governance of such an arrangement would require involvement of the ECOFIN, the Commission and even a consultation of the ECON Committee of the European Parliament. Given the extraordinary nature of such an internal consultation, that may contravene the executive authority of the negotiators of one such accord, it would be advisable for the ECOFIN and the ECON Committee to establish in advance an inter-institutional agreement to frame these negotiations more precisely than what is succinctly laid out in

the TFEU, the process laying out one such agreement. This would be a notable departure from the current practice where the ECB has tended to act under emergency interventions without consultation with the ECOFIN Council. These cases justified such emergency ECB interventions but it means that the case where exchange rate policy, in particular coordinated exchange rate policy with third parties is set by the ECOFIN council and then implemented by the ECB, without prejudice to its inflation mandate, has never been truly tested.

Box 1: Article 219 TFEU

1. By way of derogation from Article 218, the Council, either on a recommendation from the European Central Bank or on a recommendation from the Commission and after consulting the European Central Bank, in an endeavour to reach a consensus consistent with the objective of price stability, may conclude formal agreements on an exchange-rate system for the euro in relation to the currencies of third States. The Council shall act unanimously after consulting the European Parliament and in accordance with the procedure provided for in paragraph 3.

The Council may, either on a recommendation from the European Central Bank or on a recommendation from the Commission, and after consulting the European Central Bank, in an endeavour to reach a consensus consistent with the objective of price stability, adopt, adjust or abandon the central rates of the euro within the exchange-rate system. The President of the Council shall inform the European Parliament of the adoption, adjustment or abandonment of the euro central rates.

2. In the absence of an exchange-rate system in relation to one or more currencies of third States as referred to in paragraph 1, the Council, either on a recommendation from the Commission and after consulting the European Central Bank or on a recommendation from the European Central Bank, may formulate general orientations for exchange-rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability.

3. By way of derogation from Article 218, where agreements concerning monetary or foreign exchange regime matters need to be negotiated by the Union with one or more third States or international organisations, the Council, on a recommendation from the Commission and after consulting the European Central Bank, shall decide the arrangements for the negotiation and for the conclusion of such agreements. These arrangements shall ensure that the Union expresses a single position. The Commission shall be fully associated with the negotiations.

4. Without prejudice to Union competence and Union agreements as regards economic and monetary union, Member States may negotiate in international bodies and conclude international agreements.

Source: TFEU

5.3. Global financial breakdown and a new global role for the ECB

Perhaps the biggest policy challenge for Europe would be in the event of a full trade war leading to a complete collapse of the international multilateral order with possible departure of the US from the WTO (a situation that is almost already the case), the IMF and the World Bank.

This could have a number of more radical consequences for Europe and would require unprecedented policy action. In particular, the departure from the IMF would raise three large categories of questions and challenges:

i. Would the IMF need to rebuild its firepower with an increase in its arrangement to borrow and capital, which would force a new contribution by European member states? This would also impose a new discussion about voting rights and the place of large emerging economies like China and India. Would the EU decide to join forces to repatriate the IMF offices to Europe or to allow it to move its second largest shareholder, which would be Japan?

ii. How would the IMF arrange access to dollar liquidity after the dollar has left the Special Drawing Rights?
iii. How could the IMF strengthen its role as a provider of financial stability in a world where the United States would also potentially politicize the recourse to the dollar swap lines with profound consequences for the financial plumbing of the dollar-based system, the organisation of the international and monetary system?

Each of these questions would potentially raise extraordinary challenges for the euro area and for the ECB in particular. It would potentially drive the euro as the most important international reserve currency in a world that would be tremendously fragilised by the withdrawal of US. This may first result in a scramble for dollar liquidity with vast financial consequences that would require the ECB to extend bilateral swap lines to a broad range of countries and to play the role of lender- and market-maker of last resort to a much broader range of financial counterparties including clearing houses, assets managers, pension funds. This would upend the existing ECB practices in these areas entirely.

We believe the ECB should put in place some contingency planning across at least three dimensions:

- **Revising the ECB's swap line and repo agreement and preparing a bold expansion** to backstop the European financial system and assist emerging economies that would require hard currency liquidity.
- **Preparing to expand massively not only the asset purchase universe and instruments but also the list and range of counterparties** that the ECB would engage with including central clearing counterparties, exchanges, asset managers, pension funds.
- **Preparing to collaborate more actively with the IMF and other leading central banks** including the People's Bank of China (PBC) to arrange access to dollar liquidity in an environment where the Federal Reserve would refuse to provide dollar liquidity through the existing FED swap line network.

While this scenario is not our central case, it poses a sufficiently large tail risk to warrant proper policy preparation.

6. CONCLUSION

Trump's economic policies pose serious risks of trade and financial disruption. An escalating trade war, coupled with retaliatory measures and global exchange rate volatility, could severely impact the economic outlook. The ECB would be forced into uncharted territory, balancing inflationary pressures with slowing growth, creating difficult trade-offs and heightened uncertainty.

A period of economic turmoil could eventually lead to a new global economic agreement. If the crisis leads to international policy coordination, the EU may need to undertake major adjustments to its macroeconomic policy mix, including exchange rate strategy. In its 25-year history, neither the EU nor the ECB has negotiated such an agreement, meaning they would have to establish new policy coordination mechanisms and activate treaty provisions on exchange rate policy for the first time.

A worst-case scenario could see the collapse of the multilateral order, forcing Europe into a greater global financial role. If the US were to withdraw from the WTO and IMF, it could trigger a systemic shift akin to the breakdown of Bretton Woods in the 1970s. This would require European institutions to take on greater responsibility for global financial stability. The ECB, in particular, would need to expand its swap and repo operations, acting as a liquidity provider on a much broader scale, including to non-EU and non-bank actors.

The ECB must prepare for multiple economic and financial contingencies. The central bank will need to refine its inflation-targeting framework to account for external shocks, carefully calibrate its balance sheet reduction to avoid excessive financial tightening, and strengthen its financial backstops. It may also need to deepen coordination with EU fiscal authorities, particularly if a large-scale macroeconomic adjustment becomes necessary. In a scenario where the US politicises dollar liquidity or retreats from multilateral institutions, the ECB could face new responsibilities in stabilising global financial markets – requiring a strategic expansion of its crisis-management toolkit.

The ECB and European institutions must urgently prepare for these uncertain but increasingly probable scenarios.

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In this paper, we propose and analyse four scenarios of a second Trump administration's economic policy and its impact on Europe, ranging all the way from moderate tariffs to full trade war, a full multilateral breakdown with the US leaving the IMF down to a more cooperative exchange rate realignment agreement. We assess two trade scenarios quantitatively and outline broader policy shocks and their economic consequences. Our findings highlight significant challenges for the ECB, requiring responses to trade disruptions, financial instability, and potential global economic reordering. We offer specific policy recommendations for the ECB to navigate these uncertainties.

This document was provided by the Economic Governance and EMU Scrutiny Unit at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 20 March 2025.

PE 764.352
IP/A/ ECONMD/FWC/2024-002/C7/SC1

Print ISBN 978-92-848-2624-7 | doi:10.2861/ 3015630 | QA- 01-25-050-EN-C
PDF ISBN 978-92-848-2623-0 | doi:10.2861/ 5931216 | QA- 01-25-050-EN-N