16 November 2022

Euro macro notes

Transatlantic ties are in for a chill

- **We think US-EU trade relations could see a further deterioration after the adoption of the US Inflation Reduction Act. Gaining a leading position in the green transition race remains key for escaping the current 'stagflationary' dynamics that have captured Europe. Hence, the stakes for the EU to assert its position are higher than in previous transatlantic trade spats.**
- **The midterms have also raised questions about continued US support for Ukraine. A sudden withdrawal of US support (though unlikely) would be a game changer for the war effort. Amid growing internal divisions, we think it unlikely that the EU would make up for any shortfalls in US support and see the proposed EUR 18bn EU loan scheme for 2023 as a maximum.**

Winning the green transition race

US-EU relations have been on the mend since the Biden administration took office, with some decades-long trade disputes such as the Airbus-Boeing subsidy stand-off, finally resolved. However, new areas of contention have opened-up of late.

While EU leaders have been focussed on fire-fighting a worsening energy crisis, the US Congress has quietly passed the Inflation Reduction Act (IRA). As part of the USD 369bn of energy and climate related investments spending, the act includes tax credits for electric vehicles made in North America as well as provisions seeking to boost the US battery supply chain and its renewable power sector. This has raised ire in Brussels amid fears that it will contribute to the loss of competitiveness of European industry. The US is the second largest export destination for European car manufacturers, accounting for 17% of exports in 2021, so the stakes are high.

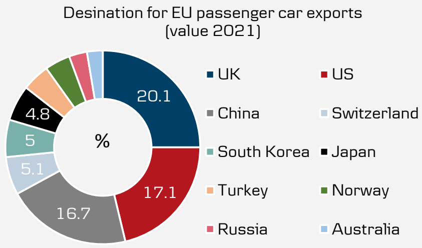
A dedicated 'task force' has been established with the hopes of winning some IRA exemptions for EU companies, similar to the ones granted for Canada and Mexico. However, amid increasing frustration of the US' protectionist moves, the EU has not ruled out legal action at the WTO if the talks do not yield any results. A joint meeting of the Trade and Technology Council, a transatlantic forum set up to align regulations, on 5 December is seen as a deadline for progress. Comments from US trade representative Katherine Tai have made it clear that there is little appetite on the US side to ask Congress to revise legislation that only narrowly passed it.

With the dispute at the core of the global green transition race and European industry's competitiveness, we see a risk of further escalation as neither side wants to back down. In contrast to Mexico and Canada, which are crucial for North American energy security, a Republican-led House will have few incentives to grant a net energy importer like Europe preferential treatment. Furthermore, the continued cosying up to China of some European countries like Germany is increasingly raising eyebrows in Washington. Brussels has also refrained from joining the wide-ranging US tech restrictions on China and the EU's carbon border adjustment mechanism remains an item of consternation in Washington. The US has countered criticism of the IRA by calling on the EU to step up its own green industrial policy and reduce reliance on China for strategically important products in the process.

US Inflation Reduction Act (IRA)

- Adopted in August 2022
- Goal is to reduce the US CO_2 emissions by 50% in 2030
- Most significant US climate legislation to date; pledges USD 369bn to further the green transition
- Incentivizes a broad set of technologies to reduce emissions and strengthen energy reliability and security, including solar, wind, geothermal, biogas, hydropower, carbon capture and sequestration, and nuclear, among others.

US is second largest export market for European car manufacturers



Source: Eurostat, Danske Bank

Senior Euro Area Analyst
Aila Mihr
+45 29 31 02 56
amih@danskebank.dk

Chief Analyst
Minna Kuusisto
Minna.kuusisto@danskebank.com

Analyst
Antti Ilvonen
Antti.ilvonen@danskebank.com

EU retaliation remains a possibility and could come in the form of increased subsidies for domestically produced EVs and green technologies. Indeed, it seems the global subsidy race has already started, with Canada last week announcing big tax credits for green tech investments to keep up with the US. If the EU can afford a subsidy war (and 'strategic autonomy' firebrands such as internal markets commissioner Thierry Breton are certainly up for it), it will likely to be an inefficient and duplicative one. That said, a full-fledged EU-US trade war remains unlikely in our view, not least as long as a foreign policy priority remains presenting a united front against Russia.

Overall, we think US-EU trade relations could see a further deterioration after the adoption of the IRA. We see an increased likelihood of the EU accelerating its 'strategic autonomy' agenda and joining the global subsidy contest. Gaining a leading position in the green transition race remains key for escaping the current 'stagflationary' dynamics that have captured Europe. Hence, the stakes for the EU to assert its position are higher than in previous transatlantic trade spats, leaving the risk of worsening EU-US ties at a time of global geopolitical uncertainty.

America vs. Europe first

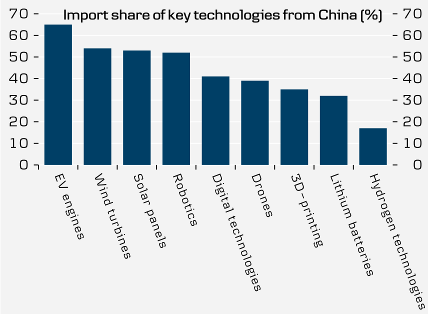
Apart from trade, questions have been raised about another area of US-EU collaboration, namely support for Ukraine. The US remains the single largest contributor to Ukraine and its role especially in supporting Ukraine's military is crucial. Some Republicans have already hinted that American support for Ukraine could come under increased scrutiny in future budgetary discussions.

For now, we expect no change in the US stance towards Ukraine: though significant in absolute terms, as a share of US GDP, its contribution amounts to only around 0.25%. We doubt it would be the first target on any Republican cost-cutting agenda. That said, the political debate around support for Ukraine will likely intensify with the start of the presidential election campaign in early 2024 and amid an increased 'America first' focus, we would not be surprised to see the US encouraging peace negotiations going forward.

The uncertainty surrounding continued US support will put the spotlight increasingly on the EU in terms funding the ongoing war effort. Ukraine's external financing needs in 2023 will amount to EUR 3-4bn per month (EUR 5bn if the destruction of Ukrainian infrastructure continues), i.e. USD 36-60bn annually. The EU Commission has *proposed* a EUR 18bn support package, in the form of highly concessional loans, disbursed in regular instalments next year and repaid in the course of 35 years, starting in 2033. The funds will be channelled through the EU budget and by allowing the EU to borrow on the capital markets. However, the proposal still requires approval by the European Parliament and EU Council. With Hungary already threatening to veto the scheme, we think it unlikely that the EU would be able to make up for any shortfalls in US support amid growing internal divisions.

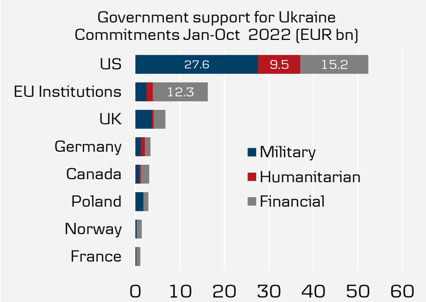
Overall, Ukraine remains highly reliant on external financing and a sudden withdrawal of US support (though unlikely) would be a game changer for the war effort. Amid growing internal divisions, we think it unlikely that the EU would make up for any shortfalls in US support. We see the EU's EUR 18bn loan package as a maximum that could still be watered down in the process of finding consensus in the EU Council and Parliament. A consequence of a more domestically focused US could be renewed impetuous for a European defence alliance and higher military spending, with many European countries currently still falling short of NATO's 2% of GDP defence spending target.

China remains a key supplier of green transition raw materials and products



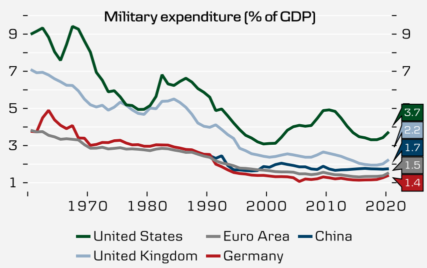
Source: EU Commission, Ifo

US remains largest supporter of Ukraine



Source: Antezza et al. (2022) "The Ukraine Support Tracker" ifw Kiel WP

EU defence spending has room to grow



Source: World Bank, Macrobond Financial, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Aila Mihr, Senior Analyst, Minna Kuusisto, Chief Analyst and Antti Ilvonen, Analyst.

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