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What to watch: US-China tariffs dilemma for Europe, one culprit for sticky US inflation and Central European central banks take a break

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Executive summary

This week we look at three critical issues:

- **US auto tariffs: Can the EU follow suit?** The bark of higher US tariffs on Chinese goods is worse than the bite: The latest move will lift the global effective US tariff rate by a meagre 0.2pp to 2.7%, and the effective tariff rate on Chinese goods by 1pp to 13.5%. However, it will bring topics such as increasing Chinese investment inflows into Mexico, trade diversion & mis-invoicing and exchange rate adjustments back into the spotlight, where they will remain as the US elections approach. The stakes are higher in Europe: It will not be easy to follow suit without hurting its own auto industry, which is much more reliant on China for profits and revenue, or jeopardizing its own green transition. China is the largest exporter of new cars to the EU both in terms of value and volume and sales of Chinese EVs have been surging. Imposing additional tariffs on Chinese EVs would mean even higher prices for European consumers, which could potentially backfire on the EU's climate ambitions.
- **Who's to blame for sticky US inflation?** Inflation remains elevated in the US, even as it drops in Europe. In April, inflation was running at +3.4% year-on-year (only -0.1pp from March), driven by still strong increases in core services and shelter prices. While fiscal policy, increasing immigration and the Fed – the latter blaming persistent supply constraints – are often listed as key reasons behind remanent inflation, we find that looser financial conditions are the number one cause, accounting for more than half of higher price pressures in 2024, even as US interest rates have been at 5.5% since July 2023. Looking ahead, the continuation of quantitative tightening should start to drain liquidity before long but we expect inflation to start to normalize only in Q4 2024 at the earliest.
- **CEE and Türkiye: Rebounding inflation will slow the monetary easing cycle.** Rising food and energy prices have brought rapid disinflation to an end in Poland, Czechia and Hungary, and we expect inflation to rise above central banks' target ranges again by the end of 2024. In Romania, on the other hand, inflation has remained stickier. As a result, we expect the pace of the current monetary easing cycles in Czechia and Hungary to slow down, while Romania and Poland with wait until later this year to cut policy rates. In Türkiye, meanwhile, inflation is set to rise to over 70% this month before starting to fall thereafter to around 40% by end-2024. The Turkish central bank is likely to keep its policy rate unchanged at 50% until inflation will have eventually fallen below this level towards the end of this year. A first policy rate cut is then possible in Q4 2024.

US auto tariffs: Can the EU follow suit?

The bark of higher US tariffs on Chinese goods is worse than the bite: We estimate the latest move by the Biden administration will lift the global effective US tariff rate by a meagre 0.2pp to 2.7%, and the effective tariff rate on Chinese goods by 1pp to 13.5%. While the US raising electric vehicle tariffs to 100% might sound significant, it is largely a symbolic move: The existing 25% tariffs along with restrictions preventing EVs with Chinese components from qualifying for Inflation Reduction Act subsidies have already curtailed imports of Chinese EVs. In fact, China is not among the top five countries of origin for imported cars in the US and very few EVs sold in the US are imported from China. The new tariffs will target USD18bn of Chinese goods imports, i.e. a modest 4.2% of the total, and are mostly focused on batteries, for which China is still a major supplier to the US. The other products targeted – including steel products and electric vehicles – are mostly sourced from elsewhere and are very modest in scale. We estimate that the weighted average tariff rate on targeted goods will increase from 7.8% currently to 14.5% this year, 14.8% in 2025 and 28.3% by 2026. The effective US tariff rate on Chinese products will rise from 12.4% to 13.5% and the global effective US tariff rate from 2.5% to 2.7%.

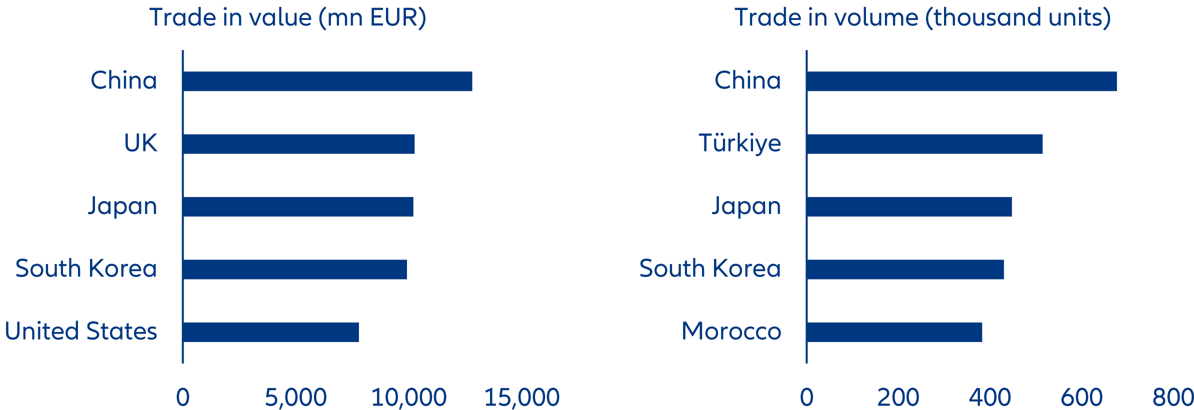
However, the move will bring several issues back to the spotlight, including increasing Chinese investment inflows into Mexico, and trade diversion & mis-invoicing, which are likely to remain in focus as the US elections approach. In his campaign, Trump has stepped up aggressive rhetoric against vehicles imported from Mexico, which face very small duties (2.5% on average) and are increasingly produced by Chinese carmakers to circumvent prohibitive tariffs for Chinese exports to the US. Increasing Chinese-made vehicle imports from Mexico could thus reignite trade tensions between the US and Mexico, even if Biden is re-elected. Furthermore, trade diversion of Chinese exports to the US via third countries to avoid duties, as well as under-reporting or mis-invoicing of imports by US importers, may increase, prompting the US authorities to crack down at some point. As we wrote recently[1], Trump may well forcefully crack down on this issue should he win a second term, which would potentially push up US inflation substantially. It is noteworthy that the US Trade Representative recommends more resources to be put toward tariff enforcement. The two-year duty waiver on solar panels from some South-East Asian countries – where there is evidence that they are rerouted Chinese products – expires next month. Punitive tariffs may be imposed.

The stakes are higher for Europe. It will not be easy to follow suit without hurting its own auto industry. China is the largest exporter of new cars to the EU both in terms of value and volume (Figure 1), and sales of Chinese EVs have been rising significantly. Given the threat posed by cheap Chinese EVs to European auto industries and employment[2], the EU is likely to step up its trade measures against China. Indeed, the recent series of anti-subsidy probes, beginning with the EV industry and extending to trains, wind turbines and medical devices, indicates a shift towards a tougher stance ahead. Going for a moderate increase in the import tariff would not change competitive dynamics much: If the current import tariff of 10% on Chinese-made EVs was increased to 25%, the EU would lose EUR118mn in imports per year. A 100% tariff would lead to a loss of EUR709mn in imports per year. But we do not expect the EU to act as aggressively as the US because European and especially German carmakers are far more reliant on China than their US counterparts. China is a major source of profits and revenue for major German carmakers, which account for 17.8% of new cars sold in China, compared to 8.8% for US brands. This makes them more vulnerable to potential Chinese retaliation. A shock on the Chinese automotive sector would have far greater repercussions on the German automotive sector than on the US (around 10 times greater relative to the size of the sectors). Such a shock propagating through the supply chain would have the highest impact, with 0.5% on the German car industry (Figure 2). In addition, with their large production base and cheaper costs in China, German carmakers import a notable portion of cars from China to Europe. In this context, higher EU tariffs could eventually backfire on the EU's own automakers. Other areas, such as agriculture, one of the few sectors in the EU that enjoys large trade surplus with China and is highly subsidized, could be also vulnerable to escalating trade disputes. Moreover, China could also retaliate by curtailing supplies of critical materials for batteries, such as lithium and graphite, which would further strain the supply chain and increase costs for European carmakers, exacerbating the economic impact of the trade dispute. Therefore, any decision by the EU Commission to increase tariffs on Chinese

[1] 2024-03-13-Trump_Report-AZ.pdf (allianz.com)
[2] 2024-03-21-Automotive-AZ.pdf (allianz.com)

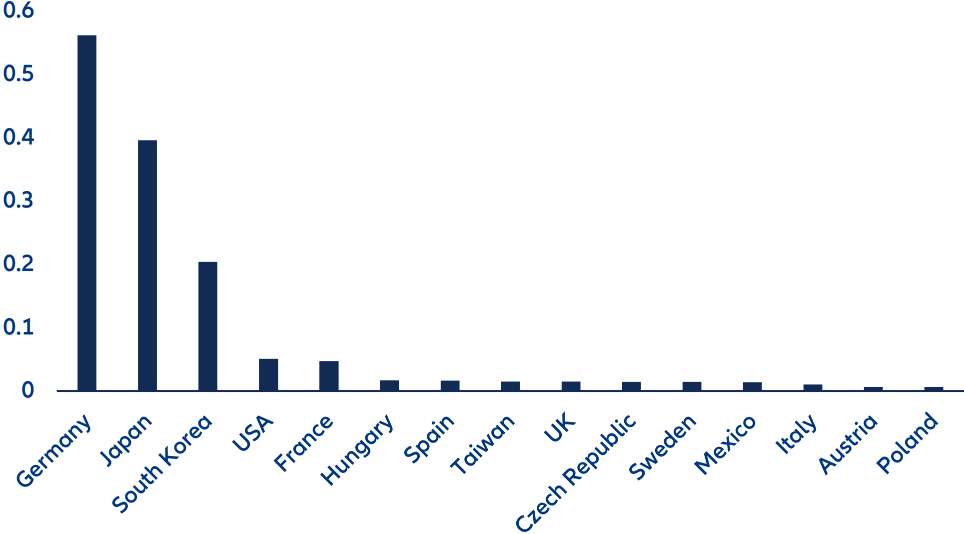
EVs must thus be accompanied by a strategy to strengthen European supply chains and access to minerals to create a pull to invest locally.

Figure 1: EU new car imports by main countries of origin in 2023



Sources: ACEA, Eurostat, Allianz Research

Figure 2: Impact of a China shock on car manufacturing by partner country, in %



Sources: WIOD, Allianz Research; Notes: Simulation of a 1:1 China shock on the automotive sector (C29) and propagation through the supply chain network by country and sector, with five rounds of shocks.

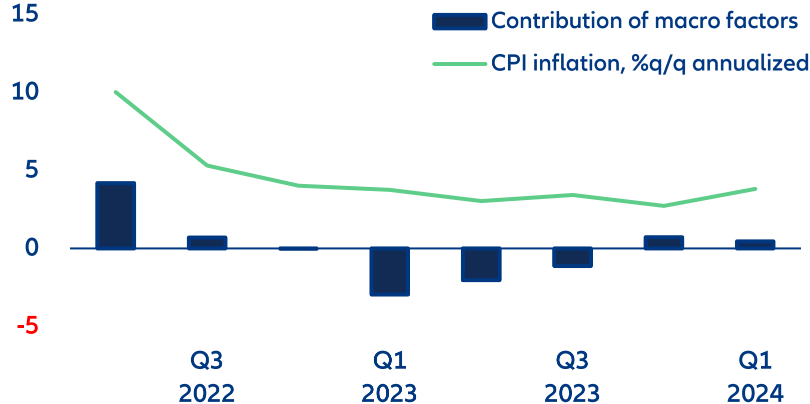
Higher tariffs on Chinese EVs could also jeopardize Europe's own green transition. With new EU CO2 emission standards already coming into effect next year, there is a pressing need for more EVs in Europe. But affordability is already the number one reason preventing European consumers from switching to electric vehicles. Imposing additional tariffs on Chinese EVs would mean even higher prices for European consumers, which could potentially backfire on the EU's Green Deal plan and jeopardize its leading position in reducing carbon emissions.

Who's to blame for sticky US inflation?

Inflation is still elevated in the US, even as it drops in Europe. After falling rapidly through 2022 and moderately through most of 2023, inflation is back in 2024 for the US. In Q1, US inflation picked up to +3.8% quarter-on-quarter (annualized) from +2.7% in Q4 2023 (Figure 3). In April, prices still increased by +3.8% month-on-month (annualized), only a modest easing from March, driven by still strong increases in core services and shelter prices. Energy prices also climbed due to higher oil prices. On a year-to-year basis, US CPI inflation rose +3.4% (-0.1pp from March), while

core inflation cooled to +3.6% (-0.2pp). In contrast, in the Eurozone, inflation dropped from +2.8% year-on-year in January to only +2.4% in April.

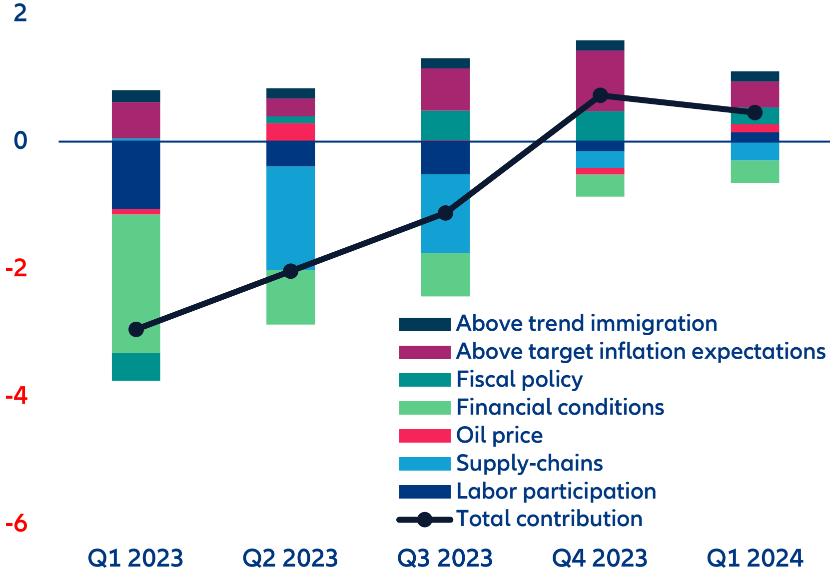
Figure 3: US CPI inflation and contribution of macro factors



Sources: LSEG Datastream, Allianz Research

What's driving the US resurgence? We find that looser financial conditions are the number one cause. For Fed Chairman Powell, supply constraints are still to blame, while others argue the Fed is not being restrictive enough yet. Still others say that the Biden administration is being too generous with fiscal policy or that the sharp rise in immigration over the past two years is to blame. To identify the biggest driver, we look at seven factors: above-trend immigration, discretionary fiscal policy, financial conditions, above-target inflation expectations, labor participation, oil prices and supply-chain disruption. The details of our methodology are laid out in the appendix. We find that the number one cause is indeed looser financial conditions, which explain more than half (54%) of higher price pressures. Their contribution has swung from -2.2 pts in Q1 2023 to -0.3 pt in Q1 2024. That is, despite much higher Fed interest rates (which peaked at 5.5% in July 2023), financial conditions have become increasingly loose (i.e. lower corporate bond yields and the rise in stock market yields, market indicators and banking indicators indicate high liquidity), fueling price pressures. Against a backdrop of still excess liquidity, banks have been able to increase their reserve balances further in recent months as money market funds have absorbed bond issuance in their place. Fading labor participation (36%) and loose fiscal policy (21%) come next, while easier supply-chain conditions (-10%) and lower inflation expectations (-5%) have helped to offset these effects somewhat, even though the latter remained above the Fed's 2% target. However, the contribution from immigration was close to neutral.

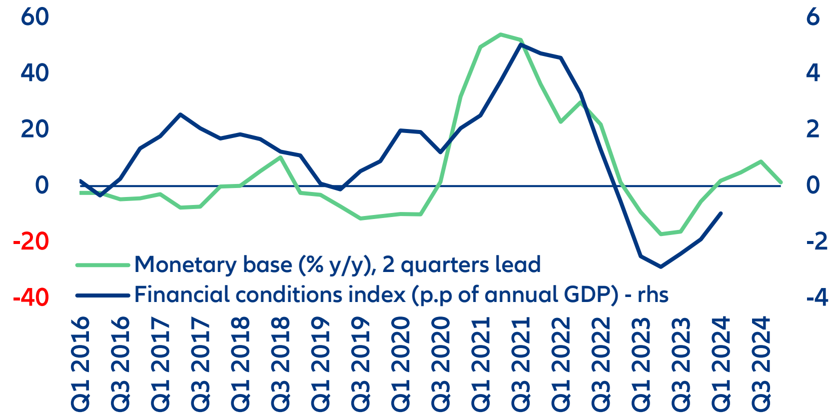
Figure 4: Breakdown of macro-factors contribution to quarterly annualized US CPI inflation (in p.p.)



Sources: LSEG Datastream, Allianz Research

Looking ahead, it could take until Q4 for price pressures to cool off convincingly amid excessive liquidity. We expect the fiscal impulse to turn negative in 2024, with signs already visible in Q1 data. At the federal level, the debt-ceiling agreement reached last year is constraining growth in discretionary spending, and at the state & local (S&L) level, governments have enacted modest tax increases overall. Therefore, we expect fiscal policy to become a (modest) drag to inflation in the coming quarters. But the pick-up in the growth of the monetary base (banks' reserve balances at the Fed + currency in circulation) – a proxy for liquidity – signals a further loosening of financial conditions ahead (Figure 5). Looser financial conditions and entrenched above-target inflation could also start to weaken the Fed' anti-inflation credibility credentials, pushing up inflation expectations. Inflation expectations have indeed started to rise again in April and May in several surveys. Against this backdrop, the continuation of quantitative tightening (QT) by the Fed – though at a lower pace from June – should start to drain liquidity before long. In all, we now expect inflation to start to normalize, i.e. to fall convincingly below 3%, in Q4 2024 at the earliest.

Figure 5: Monetary base growth & financial conditions

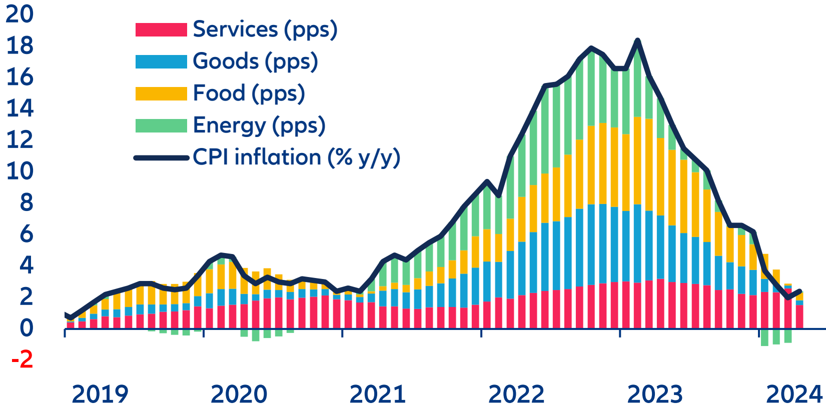


Sources: LSEG Datastream, Allianz Research

CEE and Türkiye: Rebounding inflation will slow the monetary easing cycle

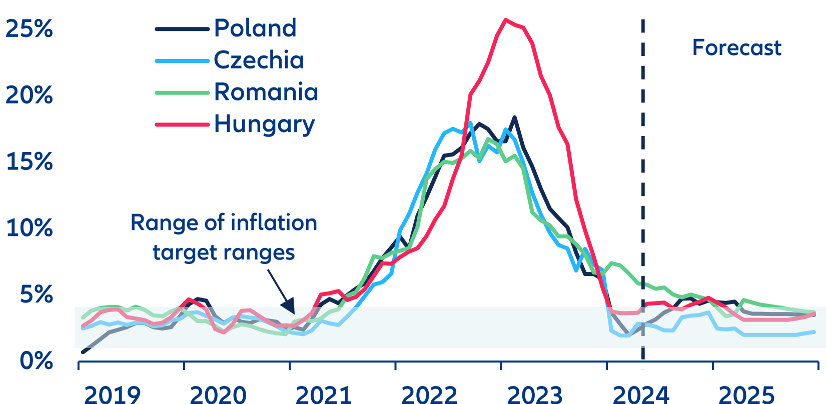
Disinflation has come to an end in key markets in Central and Eastern Europe (CEE) and we expect inflation to rise again or remain above central banks' target ranges until the end of 2024. The decline in headline consumer price inflation across CEE over the past year was larger than expected, mainly due to strong base effects, namely the rapid weakening of food and energy prices after they had surged from 2022 to early 2023 (see Figure 6 for Poland as an example). However, the latest data for April shows an inflation rebound in Poland (2.4% y/y, March 2.0%), Czechia (2.9% y/y, March 2.0%) and Hungary (3.7% y/y, March 3.6%). The reversal was mainly driven by a stronger increase in food prices; in Poland, the reintroduction of higher VAT contributed to this. In Poland and Czechia, increased fuel prices also played a role, reflecting the recent rise in global oil prices. Higher food and energy inflation should also be expected for the rest of the year as the above-mentioned base effects fade. In Romania, meanwhile, inflation has remained stickier; although it fell further to 5.9% y/y in April, it remained the highest in the region. Looking ahead, we expect headline inflation in Poland (4.6% y/y in December), Czechia (3.7%) and Hungary (4.8%) to rise above central bank's target ranges once again by the end of 2024, and to remain elevated in Romania (4.7%).[3] In 2025, inflation is forecast to gradually ease and return to the upper half of the target ranges, except in Romania where this could take until early 2026 (Figure 7).

Figure 6: Inflation components in Poland



Sources: LSEG Datastream, Statistics Poland, Allianz Research

Figure 7: Inflation outlook in Central and Eastern Europe



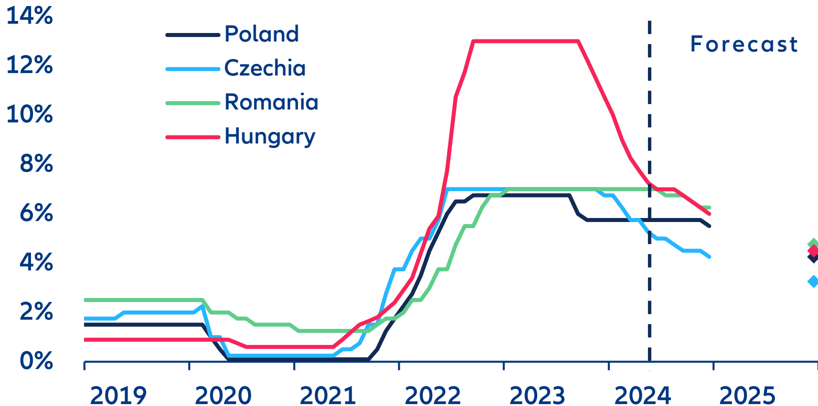
Sources: LSEG Datastream, national statistics, Allianz Research

We expect monetary policy in CEE to be cautious until the end of 2025, given the inflation outlook, with central banks likely to keep real policy interest rates in positive territory. Apart from the expected inflation rebound outlined above, there are a number of other reasons for prudent monetary policy in the CEE region in the coming

[3] *The central bank target inflation ranges are 2.0% ± 1pp in Czechia, 2.5% ± 1pp in Poland and Romania and 3.0% ± 1pp in Hungary.*

quarters, including the expectation of a more moderate monetary easing cycle by the Fed and perhaps also the ECB, oil-price uncertainty in the wake of the ongoing crisis in the Middle East, as well as strong wage growth and loose fiscal policy in Poland, Hungary and Romania (these concerns are less pronounced in Czechia). Moreover, economic activity indicators for Q1 point to improved growth prospects driven by domestic demand (in particular in the services sector), meaning that less monetary stimulus may be required this year. Against this backdrop, we expect the Polish central bank, which started the monetary easing cycle in CEE with two rate cuts in September-October 2023, to keep its policy rate unchanged at 5.75% until Q3 2024 at least, followed by a possible cut by 25bps in Q4 as the renewed rise in inflation comes to an end. The Romanian central bank has not yet pivoted but is expected to lower its policy rate by a cumulative 75bps in the second half of 2024 to 6.25% at year-end. Czechia has cut its policy rate by a total of 175bps over the past six months but is expected to slow the easing cycle with a further cumulative 100bps decline to 4.25% at end-2024. Hungary's monetary easing cycle has been the most aggressive so far, with seven rate cuts totaling 525bps since October 2023, but the easing cycle was already slowed in April. We expect another 50bps cut next week and then five more 25bps cuts over the rest of the year, so that the year-end rate comes in at 6.00% or so. In 2025, we forecast further moderate rate cuts across the region, broadly in line with falling inflation, but policy rates are still likely to be higher at the end of next year than before the pandemic (Figure **8**).

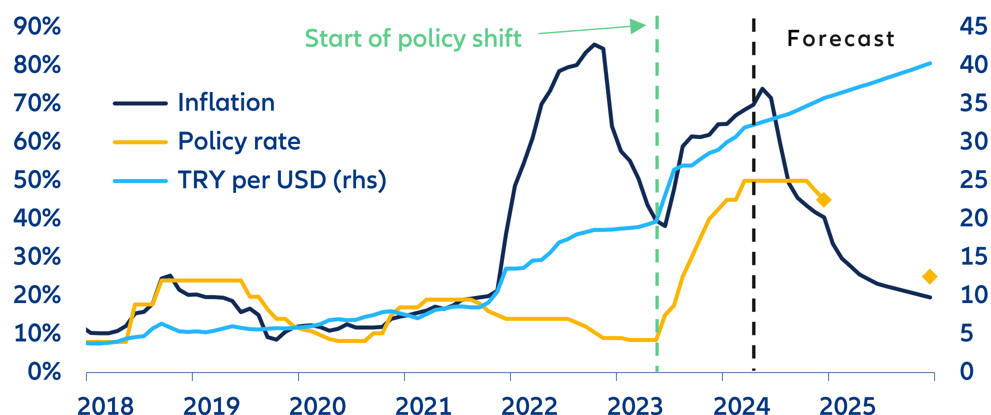
Figure 8: Policy interest rate outlook in Central and Eastern Europe



Sources: LSEG Datastream, national statistics, Allianz Research

In Türkiye, headline inflation is expected to gradually decline after peaking this month, allowing the central bank to begin a cautious monetary easing in Q4. The shift to a more orthodox economic policy stance after the general elections in May 2023 – the key policy rate was raised from 8.5% to 50.0% by March 2024, for example – has led to a strong, steady rebound in inflation from 38.2% y/y in June 2023 to 69.8% in April 2024, mainly due to tax hikes, the sharp TRY depreciation after the Central Bank of Türkiye (CBRT) halted its excessive FX interventions and a large minimum wage hike at the beginning of 2024. We expect inflation to rise once more this month to around 74% y/y, but it should begin to fall thereafter as the base effects from the surge in mid-2023 will kick in. The austerity measures announced by the Turkish Ministry of Finance this week – mainly a freezing of most public construction projects and non-essential public sector purchases – will help to lower inflation in the coming years. Assuming that the orthodox policy stance will be maintained and the somewhat managed exchange rate (allowing for a monthly depreciation of the TRY by 1.0% to 1.5%) will be continued, we forecast year-end inflation rates of around 40% in 2024 and 20% in 2025. The CBRT should remain committed to a tight monetary policy stance and keep the policy rate at 50.0% until inflation will have eventually fallen below this level towards the end of this year. We expect the CBRT to embark on a gradual monetary easing cycle in Q4 and forecast year-end policy rates of around 45% in 2024 and 25% in 2025, thereby keeping the real policy rate in positive territory at all times (Figure 9). The upside risks of this scenario (higher inflation and interest rates) include a discontinuation of the fiscal tightening process, a too early start of monetary easing as well as a significant deterioration in external financing conditions, which could lead to a stronger depreciation of the TRY than currently expected.

Figure 9: Inflation, interest and exchange rate outlook in Türkiye



Sources: LSEG Datastream, national statistics, Allianz Research

Appendix: The seven macro-factors driving US inflation

We estimate a simple Phillips curve whereby quarterly CPI inflation is explained by the output gap (growth relative to its potential), oil prices, supply-chain disruptions and one-year ahead inflation expectations[4].

We run rolling regressions of our Phillips curve to consider the changing relationship between inflation and its drivers, notably because inflation has become more responsive to the output gap since the pandemic[5].

The impact of fiscal policy, immigration, labor participation, and financial conditions on inflation are estimated indirectly through the output gap. Looser fiscal policy[6]and easier financial conditions[7] will increase the output gap by supporting aggregate demand, ultimately pushing up prices. Higher labor participation[8], on the other hand, will decrease the output gap by stimulating aggregate supply, thereby easing price pressures. For above trend immigration[9] we consider both the supply-side channel (more immigrants boost the number of jobs, hence aggregate supply) and the demand-side channel of higher rental prices (more shelter needed for newly arrived immigrants). In line with the literature, we find that immigration has a close to neutral impact on inflation, with the demand-side and supply-channel broadly cancelling out[10].

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[4] *The output gap is constructed using a HP filter. For supply-chain disruptions, we use the NY Fed's Global Supply Chain Pressure index. For 1-year ahead inflation expectations, we use the Cleveland Fed measure mixing financial markets and households' expectations.*

[5] *In economic terms, it means that the slope of the Phillips curve has steepened, consistent with elevated labor shortages.*

[6] *We measure discretionary fiscal policy by stripping out the effect of the economic cycle on the fiscal deficit using the PIIE methodology (Reducing Government Debt Ratios in an Era of Low Growth – July 2016). We assume an average fiscal multiplier of 0.9 spread over three quarters (ie $1 of additional government spending or tax cut supports GDP by $0.9 after three quarters), though we acknowledge the large uncertainties around the size and persistence of fiscal multipliers in the literature.*

[7] *We use our in-house Financial Conditions Index (FCI) built in a VAR framework encompassing GDP, real S&P Shiller house prices, real S&P 500 stock market index, and real 10-year corporate bond yield. Our FCI is built in GDP growth terms.*

[8] *We look at the share of working-age people (15 to 74) into the labor force.*

[9] *We rely on Goldman Sachs' estimates of net immigration (US Daily: Do the Official Statistics Fully capture the Recent Surge in Immigration? - 17 April 2024): they calculate that US net immigration was around 1.4 million in 2022 and 2.5 million in 2023, ie 0.4 million and 1.5 million above trend, respectively.*

[10] *From Goldman Sachs and the Census' estimates, we infer that roughly 70% of new immigrants found a job. In total, we find that new immigrants supported total US employment growth by 0.7%-point in 2023. Finally, we assume that these new immigrants lower the aggregate productivity level by decreasing the labor-to-capital ratio. On the demand side, we take the literature' estimate that an inflow of immigrants equivalent to 1% of the population push up rental prices by 1%, or 0.35% of the CPI.*

These assessments are, as always, subject to the disclaimer provided below.

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