Electrify Europe

- A proper European Union (EU) growth strategy might deal better with a protectionist US administration than engaging in retaliatory action. "Green growth" – e.g. via electrification – would be in the EU's economic interest given the magnitude of the income transfers to the rest of the world Europe's imports of fossil fuel entail.
- The real economy side of the dataflow calls for speedy action by the European Central Bank (ECB).

The appointment of Scott Bessent – generally seen as a pragmatist – at the Treasury, after the more radical Howard Lutnick at the Department of Commerce, suggests that Donald Trump may not have made a hard choice on how far he wants to dial up the pressure on tariffs. We investigate Bessent's recent comments. As many US economists – including mainstream ones – his main bone of contention with Europe is the lack of demand there, which restricts the capacity to build up a mutually beneficial trade relationship. Developing a proper growth strategy in the EU would not necessarily protect Europe fully from the US protectionist temptations, but it could be a more fruitful strategy, down the line, than merely engaging in retaliatory action, even if it is carefully targeted. Empirical evidence collected across the US at the time of the first trade war with China suggests that even where economic losses from the Chinese retaliation were locally tangible, this did not alter the political dynamics in favour of protectionist policies.

The energy transition could be a key area for such EU growth strategy. This may sound surprising given the current gloom on climate change mitigation. But we think it is worth re-stating that decarbonising is in the economic interest of Europe when one considers the massive income transfers to the rest of the world from the net imports of fossil fuels – notably to the US – and the long-term cost to investment of the volatility which they entail. Further progress on electrification would reduce Europe's fossil fuel bill. This would come with a daunting investment effort, but rather than seeing it purely as a cost, we should balance it against the tangible economic benefits.

Politics in France and Germany are not conducive for now to the kind of institutional upheaval which is required. In the meantime, the ECB will continue to be crucial to the European outlook. We review the latest dataflow which calls, once again, for a speedy removal of policy restriction.

Growth strategy versus tariff retaliation

The appointment of Scott Bessent as US Treasury Secretary will likely come as a relief in European policy circles. He is seen as a pragmatist, who fights with his more radical rival Howard Lutnick for the ear of Donald Trump on economic matters. Lutnick was appointed earlier as Secretary of Commerce, where he will have the chance to develop his protectionist views, but Trump's choice for the Treasury suggests that there may be a space for negotiation on these matters, rather than pure unilateral "fait accompli". Still, when looking carefully at Bessent's recent comments – before his appointment – we think it would be wrong to treat his arrival as a sign Europeans could settle back to the comfortable belief that they will have to deal with a "Business As Usual America".

Bessent wrote a substantial column in The Economist on 23 October in which he sketched out his vision for international trade. His analysis focuses on two dimensions: first, the interplay between national security and international trade, second the economic benefits from unfettered free trade. On the first point, he draws a clear distinction between trade which benefited the US from a national security point of view, explicitly taking the example of how trade with the US helped solidify the recovery of two key strategic allies, Europe and Japan, after World War II, and trade which ultimately benefitted the ambitions of a rival (China), while the globalisation of supply lines became a source of vulnerability for the US. Interestingly, Bessent when discussing national security does not mention a point routinely made in the US about Europe: the unequal financial burden sharing of defence. So far, so reassuring for Brussels. But his second point is more problematic. Indeed, on the economic benefits, he starts from the usual "distributional" angle – how the loss of manufacturing jobs to globalisation had a profound effect on the US society – but then **delves into the reluctance of key suppliers to the US to open their own borders and/or develop their own domestic demand in a way which would allow a mutually beneficial trade relationship. There, interestingly again, he mentions China, but also Japan, South Korea….and Germany**. This is where Bessent's points may start sounding the alarm in Brussels.

This has been a regular feature of the macroeconomic debate in the US. In the run-up to the financial crisis of 2008, when Europeans were increasingly worried about the ballooning current account deficits in the US, which they usually attributed to overly lax economic policy, most US policymakers laid the blame – partly – on Europe's "demand rationing" habits, which restricted US exports. The subprime crisis sealed the deal for the Europeans – overgenerous lending practices in the US were seen as one symptom of excess demand over there – but the debate never fully closed on the US side. If anything, Bessent's call for Germany to stimulate its domestic demand should further convince politicians of all ilk in Berlin to deeply – and speedily – reform their national "debt brake" to finally put their fiscal fire power to good use. More fundamentally, **we think that implementing, at the national but also at the EU level, a convincing growth strategy would be one way to "placate" the US in their current political configuration**. Irrespective of the protectionist winds blowing from the US there would be a strong case anyway to part with the mediocre performance of the last few years, but convincing the Americans that a mutually beneficial trade relationship can be strengthened thanks to stronger European demand could also be a way to avoid the worst of Washington's ire.

This may not suffice, especially since on the US side, Europe-watchers could be excused for being sceptical on the chances of implementing such growth strategy in the short run, in a situation of political instability in both France and Germany. We also note in Bessent's column his preference for "*broad-based tariff*s" which he sees as better than "*bilateral actions which largely shift imbalances around rather than address their underlying source*" which could be read as a readiness to extend tariffs well beyond China. Interestingly, Bessent does not elude the question of the US own responsibility in the build-up of global imbalances, namely by running too high fiscal deficits. But as we discussed last week, and even if Bessent mentions "spending cuts" as the solution there, the income from tariffs may prove tempting to square that equation, and hiking duties on Chinese products may not be enough.

If Europe is ultimately faced with tariffs, what response – in the realm of international trade – could it offer? While European public opinion is likely to demand "reprisals," there is room for subtlety in this matter. We would distinguish two different cases.

If European producers do face a *uniform* tariff increase that affects all exporters to the United States (US) equally, it is far from clear that it would be rational for the EU to respond. European producers would lose competitiveness only against American producers, and for many products, there is no viable American alternative, at least not in the short run. Of course, the tariff increase would incentivize more relocation of production to the US but given the already striking structural cost differences between the two sides of the Atlantic (energy prices, regulations), a 10% tariff hike would not necessarily shift the balance significantly, especially if a sustained depreciation of the euro at least partially offsets the impact. Adding further costs by imposing uniform tariffs on American products in retaliation, which would harm European consumers, would only worsen the overall economic toll.

The calculus changes if, instead of a "generic" tariff increase applied to all products from non-Chinese trading partners, the US opts for a more targeted approach, focusing on products where Europe has a significant competitive advantage, where the US market is crucial, and where the impact on technological competition is significant. In such case, European producers would often be penalized not only relative to potential American competitors but also compared to producers from third countries. Targeting technologically strategic sectors would have a more severe long-term impact on European growth. Since such US targeted tariffs would be granular, it would be correspondingly easier for the EU to implement retaliatory measures that, while minimizing the shock for European consumers, target economically or politically sensitive products in the US. A typical example would be an American product with little weight in European consumption but with significant importance for production in a Republican-held district in the US. Such an approach – continuing the strategy adopted during the transatlantic "trade skirmishes" of Trump's first term involving steel and aluminium – could potentially persuade American political circles to avoid further escalation.

However, **the political impact of retaliatory measures should not be overestimated, even when their economic effects are tangible**. A thorough NBER study by Michael Waugh (see the link here) analysed the impact of Chinese retaliation during the first trade war at the county level across the US, based on their relative intensity in production affected by countervailing duties. The difference in labour market performance was visible: employment in the counties most affected by Chinese tariffs grew 0.75% less than in others. Yet, recent election results suggest that citizens in these areas did not blame the Republicans. Wisconsin and Michigan, due to their industrial specialization, were among the states with the highest number of counties hit by Chinese retaliation, yet they swung Republican this year.

More fundamentally, Europe must ask itself whether it is in its long-term interest to engage in an ongoing escalation of the trade war. The EU's growth is structurally more dependent on exports than that of the US, which has greater reserves of domestic demand. This factor weakens Europe's credibility in such a scenario.

The double dividend from electrification

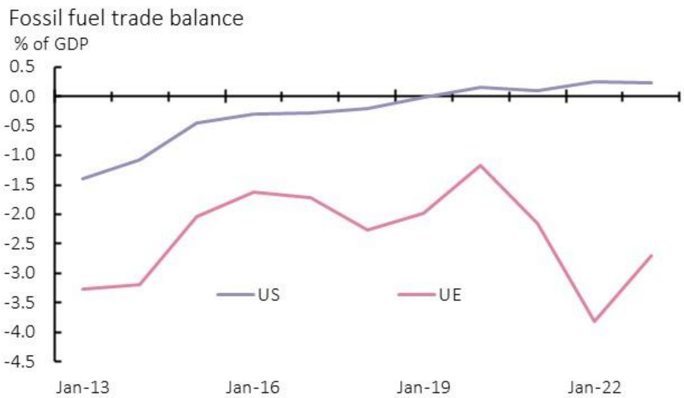
Now, assuming a "European growth strategy" could be ultimately more appropriate to deal with the new state of affairs in Washington DC, what priority – among the long list produced by Mario Draghi in his recent report – should be chosen? **We think "green growth" would be a natural place to start, which could fit the EU's values as well as prove beneficial to the continent's economic fate**. Such choice may surprise given the generic "green backlash "currently at work – we will look into the conclusions of COP next week, but we don't think we would kill suspense by presenting them at best as "a mixed bag". But it is precisely in those moments of doubt that the economic case for the net zero transition must be re-made.

A common question since Donald Trump's victory, given his pledge to take the US once again out of the Paris Treaty on the mitigation of climate change, is why the EU should continue with its own decarbonation path. Since only global action can seriously move the dial on the speed at which the planet's CO_2 budget is being consumed, and if the world's largest economy refuses to play its part, then efforts in other parts of the world could be considered as futile. We do not think this is true. Indeed, while carbon intensity in the US remains high by the standards of developed countries, it has been falling on trend irrespective of the federal government's stance, and **the main battles of the "climate war"**

will be fought in emerging nations. China is already emitting almost three times as much CO2 as the US, and India half as much (and rising fast). Beyond the exemplarity aspects, the EU can still significantly contribute to climate change mitigation despite its current low share in global emissions (6%) by using access to its market to incentivise exporters to the EU to move to a cleaner growth model themselves (this is the basis for the border carbon tax).

Another – less altruistic – argument may help convince the doubters**: moving further down the decarbonation path is squarely in Europe's economic interest by reducing a huge income transfer to the rest of the world**. The energy crisis triggered by the war in Ukraine should act as a reminder that the EU remains excessively dependent on imports of fossil fuel. Even before the 2022 shock, EU countries have been routinely paying to the rest of the world the equivalent of 2% to 3% of their GDP for their net imports of coal, gas, and oil. The contrast with the US is getting sharper: the US has become the world's biggest oil producer in 2018 and a net exporter of gas and oil in 2019. Last year, despite the beginning of a correction in gas prices, the difference in this "fossil fuel invoice" between the EU and the US stood at nearly 3% of GDP. This gap was highlighted in Mario Draghi's recent report, with a very eloquent message: *"These funds could be better used by the EU to invest in infrastructure, innovation, education, and other areas, which are essential for developed economies to keep their competitive edge in global markets*".

Exhibit 1 – Bleeding money on fossil



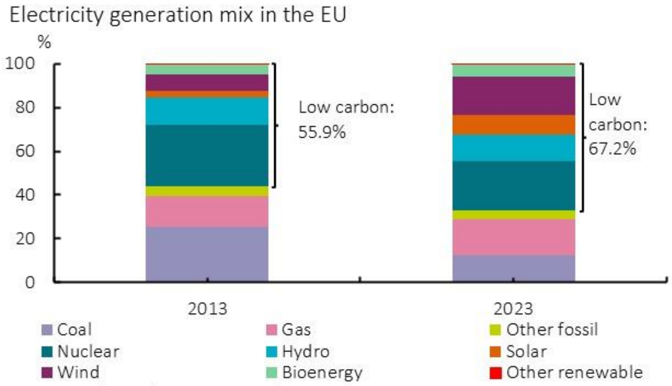
Source: United Nations Trade And Development and AXA IM Research, November 2024

Beyond the "income loss" channel, we would add that **the price gyrations inherent to fossil fuels entail a cost to *potential* growth in the EU**. Indeed, the attached volatility entails a constant "uncertainty premium" on economic activity. To make this more intuitive: the immediate impact of the rise in gas prices in 2022 was a short-term decline in consumers' purchasing power – partly mitigated by additional government spending generating more debt issuance – but also triggered a "wait and see" attitude on investment from businesses, especially the most energy-intensive ones, which will leave scars on Europe's productive capacity for the future.

Volatility in fossil fuel prices could ultimately rise, rather than fall, with the US becoming an ever-larger producer. Indeed, the US tolerance to disruptions in supply from the Persian Gulf has naturally risen as a consequence of this growing energy autonomy. Irrespective of ideological choices, this could contribute to a shift in Washington DC on how escalation risks in the Middle East should be assessed. Benign neglect cannot be fully warranted, because the price of oil is set on the global stage, and US consumers would still be immediately affected – and consumers are also voters who are more numerous than domestic producers – but it still changes the terms of the calculus. Separately, the EU's growing dependence on the US for its gas supply as replacement to Russian sources is a vulnerability in the looming battle on international trade.

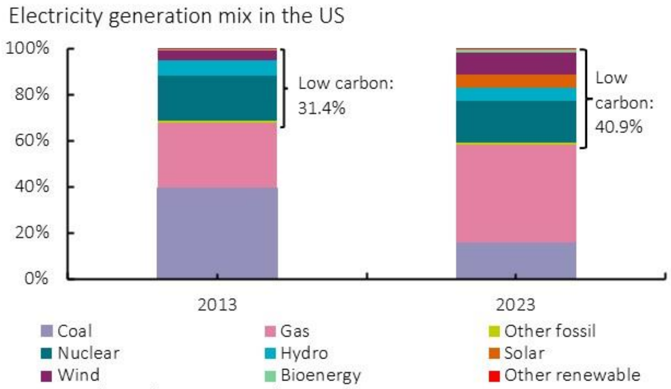
Electrification is one of the ways forward for the EU. Indeed, European electricity generation is already two-third low-carbon (renewables + nuclear), from a little over 50% 10 years ago (see Exhibit 2). There has also been some progress on the US side, but fossil fuels still account for almost 60% of power generation, with coal being replaced by gas (see Exhibit 3). In the EU, 1 kwh of electricity emits around 200 grams of carbon, against nearly 400g in the US. The EU plans to bring electricity to 30% of primary energy consumption by 2030 – from 23% today – and then to 50% in 2050. Even assuming no further decarbonation of electricity generation itself, the mere fact of raising its share in the overall energy mix of Europe would reduce the EU's carbon footprint and its dependence on fossil fuel markets. Since a growing part of European fossil fuel imports come from the US, reducing these transfers could ultimately be a better way to "offset" potential trade tariffs levied in America on European products than retaliatory tariffs.

Exhibit 2 – Already quite decarbonated in the EU



Source: Ember and AXA IM Research, November 2024

Exhibit 3 – US lagging markedly behind



Source: Ember and AXA IM Research, November 2024

The price of renewables has been falling on trend. In 2010, using the Ember data, in Germany 1Mwh of onshore wind electricity cost EUR141. This fell to EUR58.25 in October 2024. The decline has even been steeper for solar (from EUR323 to 58.25). **This is now roughly half the cost of gas**. Yet, massive investment will still be needed to scale up low carbon, cheap power. For instance, beyond the direct expansion in low-carbon production capacities, raising the *grid* capacity would help alleviate intermittency issues – better connecting high producing areas, wherever they are in Europe, with consumption centres – thereby reducing the need to resort to fossil fuel production in peak consumption times when nuclear power cannot bridge the gap. While "most of the time" solar and wind tend to complement themselves well, at the beginning of this month, the North of Europe has been hit by a "dunkelflaute" – a phase in which both wind and solar capacity is producing little. As a consequence, electricity production in Germany was – for a week – coming at 70% from fossil fuel (gas and coal).

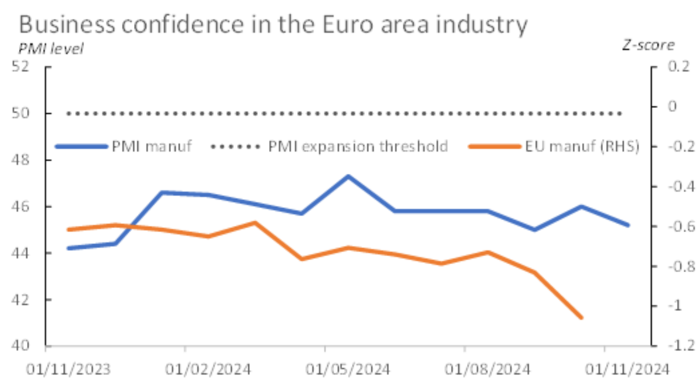
Based on the Commission's European Grid Action Plan, published in November 2023, €584 billion in investment will be needed by 2030 to meet this growing electricity demand. **These investment needs often appear daunting, especially in times of weak underlying growth and with constrained public finances limit the possibility to heavily subsidy the efforts, but this should be balanced against the long-term benefit** of reducing a structural income transfer from Europe to the rest of the world and lower price volatility. Of course, we must not be naïve: electrification will not address all Europe's supply vulnerabilities. To some extent, it will create new ones – for instance, on minerals "rare earth" which are currently mined in only a handful of countries and are key to the production of batteries. But in many cases, these dependencies will be mostly located at the investment or production stage, rather than down the line at the consumer level. This changes the political sensitivity of the issue.

Turning 50?

None of this is for immediate consumption though. For the time being, in the absence of clear political leadership in the two usual "tone setters" of the EU, France and Germany, **the immediate economic European outlook rests more in the hands of the ECB.** There is still a bit of time before the next Governing Council meeting on 12 December, but the most recent dataflow on the real side of the economy reinforces the call for a speedy removal of monetary restriction. The composite Purchasing Managers' Index (PMI) for the Euro area fell unexpectedly to 48.1 in November from 50.0 in October. It already had a short foray in contraction territory in September, but it was much shallower (49.6). When looking at the sectoral breakdown, what is striking is not that manufacturing continues to wallow deep in contraction –

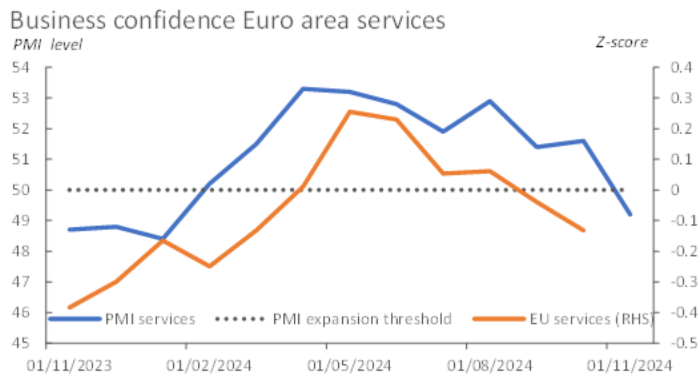
this has been going on for a long time now (see Exhibit 4), but that the services sector, which had shown signs of improvement in the spring, is now also contracting (see Exhibit 5). True, the PMI has not been a great predictor of GDP in recent quarters, but the message from the European Commission survey is not divergent. Business confidence in the services according to this source has moved – slightly – below its long-term average in October.

Exhibit 4 – Manufacturing in contraction for a while



Source: Macrobond, EU Commission, AXA IM Research, November 2024

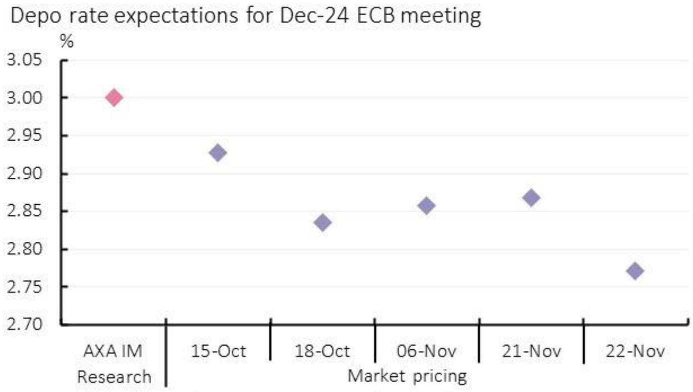
Exhibit 5 – Services now joining



Source: Macrobond, EU Commission, AXA IM Research, November 2024

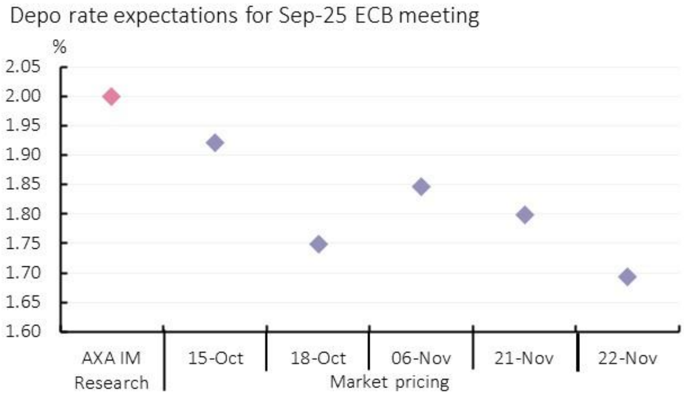
We will get the November print for the Commission survey this week on Thursday. A confirmation of the message from the PMI could tilt the conversation towards a 50 basis-point cut. The market is already there (see Exhibit 6). We would agree in principle were it not for the statements from well-known doves, such as Yannis Stournaras who, although he did not explicitly rule out a 50bp cut, indicated in an interview last week his preference for a steady pace of 25bp cut at every meeting down to the neutral level which he puts at "around 2%". Some developments on the price front may explain this relative prudence. While we think it mostly reflects lagged developments in Germany, the jump in negotiated wages to 5.4%yoy in Q3 did not help. More fundamentally, it seems that Stournaras wants to "reserve" 50bp cuts to respond to potential policy moves from the incoming US administration. In any case, the magnitude of the December step matters less in our view than the overall trajectory. **Stournaras stated that it was too early to say whether the ECB would need to ultimately break the 2% "neutral rate" threshold to get into accommodative territory. The market is already there** (see Exhibit 7). A terminal rate at 2% has been our baseline, but without clear growth initiatives emerging in Europe in the short run – and given the political setup this probability is shrinking – we will be getting more and more sympathetic to that view.

Exhibit 6 – Market pricing a 50bp cut in December…



Source: Bloomberg and AXA IM Macro Research, November 2024

Exhibit 7 – …and into accommodation "proper" next year



Source: Bloomberg and AXA IM Macro Research, November 2024

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Trump continues to appoint cabinet; picks lean to implementing more unorthodox policies • Philly Fed survey (Nov) fell to -5.5 – a 3-month low, contrary to Empire State's 3-year high • Jobless claims rise 213k, a 7-month low, but continuing claims have climbed to a 3-year high • Housing starts (Oct) -3.1%, but home sales +3.4%	• PCE inflation (Oct) headline expected up to 2.3% on oil, but core also up to 2.8% – stuck above 2% • GDP (Q3, r) little revision expected from 2.8% (p) • Jobless claims – watch continuing claims for further increases despite low weekly claims • Chicago PMI (Nov) fell in Oct, mfg appears stuck at subdued pace
	• Flash PMIs have depicted a fast weakening eurozone growth picture with composite output index down 1.9pts to 48.1 in November • German Q3 GDP growth was revised down to 0.1%qoq (-0.1ppt). Bundesbank expect flat growth in Q4 24	• German Ifo & EC surveys for November • We project euro area "flash" headline HICP to edge up to 2.3%yoy (from 2.0%) while core should remain unchanged at 2.7%yoy in November • Flurry of ECB speakers continue
	• CPI inflation (Oct) rose to 2.3%, from 1.7%. Core ticked up to 3.3%, from 3.2%, while services inflation rose to 5.0%, from 4.9% • Public sector net borrowing (Oct) came in above expectations at £17.4bn • GfK cons. conf. (Nov) edged up to -18, from -21 • Retail sales (Oct) fell by 0.9%mom, below the expected 0.4% drop • Flash PMIs (Nov) fell back below 50	• Nationwide House Prices (Nov) despite rise in risk-free rates passing through to higher mortgage rates, prices will be supported stronger demand in the run up to the SDLT thresholds increasing in the spring • Consumer credit (Oct) likely took a step down as uncertainty rose • Mortgage approvals (Oct) as will prices, approvals will be boosted by the SDLT changes
	• Exports (Oct) were up 3.1%yoy • CPI inflation (Oct) fell to 2.3%, from 2.5%, but underlying inflation – ex. energy and fresh food – rose to 2.3%, from 2.1%. above expectations • Composite PMI edged up to 49.8, from 49.6	• Tokyo CPI inflation (Oct) looks for signs that weaker yen is passing through to prices • Consumer confidence (Nov) likely will remain weak • Retail sales (Oct) likely remained subdued as caution persists • IP (Oct) global uncertainty liekly weighed on output
	• Loan prime rate in November unchanged at 3.1% and 3.6% for 1-year and 5-year respectively	• Industrial profit for Jan-Oct • NBS mfg PMI and non-mfg PMI
	• CB: Indonesia (6%), Hungary (6.5%), Turkey (50%) on hold, South Africa 25bp cut to 7.25% • CPI (Oct yoy): Hong Kong (1.4%), Malaysia (1.9%), South Africa (2.8%) • GDP (Q3 yoy): Chile (2.3%), Colombia (2%), Thailand (3.0%)	• CB: Korea (3.25%) on hold • CPI (Oct): Singapore, Brazil • GDP (Q3): India, Turkey, Czech Republic • Industrial production (Oct): Korea, Thailand, Taiwan

Upcoming events	US:	Tue: S&P House price index (Sep), FHFA house price index (Sep), Consumer confidence (Nov), New home sales (Oct); Wed: GDP (2nd release) (Q3), Core PCE (2nd release) (Q3), Durable goods orders (Oct, p), Goods trade balance (Oct), Initial jobless claims (w/e 23 Nov), PCE price index (Oct), Personal income (Oct), Pending home sales (Oct)
	Euro Area:	Mon: Ge IfO business climate index (Nov); Thu: Sp HICP (Nov, p), Ez M3 supply Oct), It (ISTAT) business confidence (Nov), Ez IP (Nov), Ge HICP (Nov, p), Ge CPI (Nov, p); Fri: Fr GDP (Q3), Fr HICP (Nov, p), Fr Consumer spending (Oct), Ge Unemp (Nov), Ez ECB 1y, 3y consumer inflation expectations (Oct), Ez HICP (flash) (Nov), It HICP (Nov, p), Ge & Sp DBRS credit rating, Fr S&P credit rating
	UK:	Fri: Nationwide house price index (Nov), Mortgage approvals (Oct), Consumer credit (Oct)
	Japan:	Thu: Unemp (Oct), IP (Oct, p)
	China:	Sat: Official mfg PMI (Nov), Official non-mfg PMI (Nov)

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