



## US election implications for the euro area

- At the time of writing Trump's victory appears extremely likely. Our preliminary view is that the policies championed by Trump during the presidential campaign are likely to weigh on the already challenging euro-area outlook. That said, we do not expect a significant impact, at least in the short term. Market reactions are likely to be more material, with a risk of overshooting. Hence, the highly likely victory of Trump will initially affect the euro area via the financial channel.
- It appears that Trump is in favour of a large 2-3% of GDP fiscal stimulus program. We put forward three reasons why a large, unfunded fiscal stimulus along the unspecific lines described by Trump could translate into disappointing euro-area trade gains.
- Furthermore, based on the pre-election rhetoric, Trump's election is likely to be a negative development for trade agreements and the likelihood of a pick-up in global trade. That said, it may be premature to envisage dramatic changes in existing trading relationships. Where a Trump Presidency could cause more disruption is in ongoing and future trade negotiations such as the TPP and TTIP, which have been years in the making in any case.
- Private investment spending could be negatively affected in an already highly uncertain political outlook. In our view, there are significant uncertainties attached to Trump's policies. Political and macro uncertainty tends to lead to a postponement of investment decisions.
- According to Deutsche Bank's European equity strategists, a rise in Trump-related policy uncertainty would weigh on European equities with a downside risk for the EuroStoxx600 of 5-10%. Over the past 10 months, stress episodes, from China to Brexit, have weighed on the banking sector, particularly in Italy regardless of the direct contagion channels.
- Following Trump's highly likely victory, we expect euro-area core government yields to be lower and peripheral spreads wider. A probable increase in US yields and a decline in equity markets would likely put upward pressure on peripheral yields. Doubts about the US fiscal outlook and a risk-off scenario could also lead to a flight to safety pushing German yields down.
- The uncertainty associated with the policy outlook for the US economy could push the EUR up in the short-term. The usual negative correlation of the euro with US equities is one reason for a EUR/USD rally on the back of a Trump victory near term. In the medium-run, the effect is ambiguous.
- The above financial developments could partially hinder the transmission of the ECB's monetary policy. Furthermore, following Brexit and a Trump's victory, we expect increasing apprehension about the various political events coming up in Europe over the next twelve months. This uncertainty will constrain the euro-area recovery, underscore our expectation for a slowdown in euro-area 2017 GDP growth and further complicate the ECB's task.



## A preliminary qualitative assessment

The US presidential election looks to have brought another unexpected political outcome in a G7 economy. At the time of writing, while a Clinton win is not yet totally ruled out, Donald Trump looks extremely likely to achieve a majority in the Electoral College and become the next President of the United States.

There remains considerable uncertainty as to what policy Donald Trump's presidency would bring. For example, a large fiscal stimulus plan could be watered down by the more fiscally conservative Congress. That said, the Republicans appear set to control both the House and, almost certainly but not yet confirmed, the Senate.

## Impact on real economic variables

The US Presidential campaign did not provide enough details on Trump's economic policies. Hence, there is an elevated degree of uncertainty. Consequently, rather than providing point estimates on the repercussion for euro-area growth prospects, we focus on a qualitative discussion.

### Fiscal stimulus: limited upside to imports

It appears that Trump is in favour of a large 2-3% of GDP fiscal stimulus program. It can be argued that the US has a higher fiscal multiplier than other developed countries because of low sensitivity to the current account position, and US government yields benefitting from the US dollar status as a global reserve currency. Hence, mechanically, US fiscal stimulus could increase US growth and boost euro-area imports.

We are skeptical. We see at least three reasons why a large, unfunded fiscal stimulus along the unspecific lines described by Trump could translate into disappointing euro-area trade gains:

- First, the US current account deficit would likely increase. Hence, it can be argued that a large unfunded stimulus program could raise doubts about the US fiscal sustainability (see later section on the government yields). It follows that the sensitivity to current account deficits could become more important. Also a fiscal stimulus is most effective when a country has a negative output gap, which is not currently the case for the US.
- Second, a significantly more expansionary fiscal policy to be sustainable would require an improvement in potential GDP growth. But some of the policies advocated by Trump appear to go in the opposite direction. In other words, benefits from fiscal stimulus on short-term demand are likely to be partially offset by potentially hurtful supply-side policies on immigration and trade, lowering productivity in the short-run and the long-run (further depressing private investment).
- Third, there is a risk that a move towards a protectionist US trade policy restricts foreign imports. The trade channel is one of the main concerns and requires further analysis in the following section.

### Trade: worrisome news from the euro area's main trading partners

Based on the pre-election rhetoric, Trump's election is likely to be a negative development for trade agreements and the likelihood of a pick-up in global trade. A protectionist policy by the US would probably trigger a response by other countries. There could be a risk of ending up in the non-cooperative solution of the prisoner's dilemma.

Figure 1: US and UK represent more than 25% of euro-area goods exports

Rank	Share of total goods exports	EA % EA GDP
1 UK	13.3	2.6
2 US	13.2	2.5
3 OPEC	6.8	1.3
4 China	6.6	1.3
5 Switzer	5.6	1.1
6 Poland	5.4	1.0
7 Czech	3.6	0.7
8 Russia	3.4	0.7
9 Sweden	3.2	0.6
10 Turkey	3.0	0.6
11 Hungary	2.3	0.4
12 Japan	2.2	0.4
13 Denmark	1.9	0.4
14 Korea	1.8	0.4
15 Romania	1.7	0.3
16 Brazil	1.5	0.3
17 India	1.5	0.3
18 Mexico	1.3	0.3
19 Canada	1.27	0.2
20 Norway	1.14	0.2

Goods exports: Average (2014-2015)  
 Source: Eurostat, Haver Analytics LP, Deutsche Bank



For euro-area trade, recent political events are problematic. [The UK and the US account for more than a quarter of the euro area's total exports](#) (Figure 1). Euro-area trade with the UK is likely to be weakened by Brexit, at least in the medium term. Now, trading links with its second-largest partner are also at risk of deterioration.

[That said, it may be premature to envisage dramatic changes in existing trading relationships:](#)

- It is unclear that the US President can unilaterally withdraw from a treaty. As highlighted by Deutsche Bank's US Economist Brett Ryan, theoretically, from a strict interpretation of the Constitution, it may be possible, but it would almost certainly be challenged in court by many US domiciled companies.
- Indeed, domestic opposition from the corporate sector would also play an important role not too dissimilarly to what is currently happening in the UK against the possibility of a hard Brexit. For example, US auto makers and many other industries have significant committed investments in Mexico and China.
- One should also note that the only time the US voted to cancel a trade treaty in history was in 1866 (w/ Canada).

[Where a Trump Presidency could cause more disruption is in future and ongoing trade negotiations](#) such as the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP), which have been years in the making in any case.

**Box 1: How hurtful could a US protectionist turn be for the Euro area?**

To answer that question, we estimate the potential reduction in Euro-area GDP through two methodologies.

On the one hand, the impact following a mechanical approach could be small. It is very hard to gauge how Trump's policies would reduce US imports from the euro area. We choose a 10% shock for three reasons: (i) It is an easy reference number to scale up or down; (ii) our earlier research on the impact of imposing WTO tariffs on EU exports to the UK chimes with that order of magnitude; and (iii) such a shock would be equivalent to a one-standard deviation shock to euro-area export growth.

Our estimates account for the mechanical reduction of GDP due to a reduction of exports and the partially-offsetting effect coming from the import-content of exports. The impact would be relatively minor. It would decrease euro-area GDP by ~0.2pp. Germany's GDP would be hurt by ~0.3pp, while the other Big4 countries would be hurt by ~0.1pp.

On the other hand, weaker global growth could have a more significant impact: Trade retaliations from other countries, uncertainty and lower investment could hurt global GDP growth. We estimate the impact of a 1pp fall in the external demand faced by the euro area. Our estimates account for the changes in exports, imports and machinery investment. In that scenario, the Euro-area's GDP could be reduced by ~0.3pp. The impact would vary from ~1pp in Germany to ~0.2pp in France and Spain, while Italy would be hit by ~0.5pp.

Besides bilateral trade relationships, Trump's foreign policy comments during the campaign suggest that a rise of geopolitical risks. Tensions in Eastern Europe should also be carefully scrutinized.

**Figure 2: Ireland, Belgium and Germany most exposed to US**

Goods exports to US as % of total goods exports	% total goods exports	% GDP
Ireland	23.0	10.3
Belgium	5.7	5.0
Germany	9.0	3.5
Netherlands	3.8	2.9
Austria	5.9	2.4
Italy	8.0	2.0
Finland	6.9	1.8
France	6.8	1.4
Portugal	4.7	1.3
Spain	4.4	1.0
Greece	3.8	0.6

Goods exports :Average (2014-2015)  
 The total goods exports include exports to other euro-area countries  
 Source: IMF, Haver Analytics LP, Deutsche Bank



#### [Investment: dampened by further political uncertainty](#)

Political and macro uncertainty tends to lead to a postponement of investment decisions as we have illustrated in [Focus Europe on 4 November](#). Further political uncertainty from the US would add to the current headwinds from Brexit and the packed European electoral schedule over the next 12 months.

#### [Central Bank independence is fundamental](#)

Trump has been very vocal in his criticism of the Fed and Yellen during the campaign. Trump has proposed Fed audits and replacing Yellen. The implementation of such actions could decrease the actual or at least the perceived independence of central banks.

The move towards independent central banks is widely viewed as a positive economic development. Volcker's success at ending the high inflation rates of the 1970's, and the lower inflation rates experienced in the last 30 years are clear demonstrations of it.

Will a Trump's victory lead to a more "dovish" or "hawkish Fed? *In the short term* only a material impact on financial conditions, i.e. a severe, persistent equity market/emerging market selloff and US dollar appreciation, would cause the Fed to hesitate. Conversely, a large fiscal stimulus could accelerate the tightening path. *In the medium-term*, Trump's victory could lead to a more hawkish Fed.

#### [Box 2 Brexit and a Trump Presidency](#)

We have mentioned above that Brexit and a victory of Trump are not encouraging developments for euro-area's exports. That said, the consequences of Trump's election on the Brexit process is unclear:

- On the one hand, the prospect of losing further export markets may push the EU towards a more accommodative stance with the UK.
- On the other hand, many US firms appear to have large retained earnings in the UK. The large tax repatriation program defended by Trump could put more pressure on the UK current account funding and weaken the UK's bargaining position.

## Impact on financials

#### [European equities: lower](#)

According to Deutsche Bank's European [equity strategists](#), a rise in Trump-related policy uncertainty would weigh on European equities with a downside risk for the EuroStoxx600 of 5-10%. They believe that Trump's victory could be positive for Pharma and US-exposed infrastructure companies. They would remain cautious on banks. Over the past 10 months, stress episodes, from China to Brexit, have weighed on the banking sector, particularly in Italy regardless of the direct contagion channels.

#### [EUR government yields: core yields lower, peripheral spreads wider](#)

Deutsche Bank's US fixed [income strategists](#) think that Trump's more ambitious fiscal plans could cause 10Y USTs to increase to 2.4% by the end of next year, 40 bps higher than their base case under a Clinton presidency. Although, as we argued above, the US benefits from its reserve currency status, US yields are not insulated from inflation risk or term premia, which is generally thought to increase more in a Trump scenario.



We think that euro-area peripheral spreads would widen:

- Higher rates in the US and lower equity markets would likely put upward pressure on peripheral yields.
- Doubts about the US fiscal outlook and a risk-off scenario could also lead to a flight to safety pushing German yields down.

A rising demand for German bonds would increase the scarcity issues faced by the ECB in its QE program. However, we do not believe that the widening of spreads would be perceived as a systemic, persistent crisis capable of reducing the political hurdles for moving QE purchases away from capital key towards outstanding debt.

#### Oil prices: not a game changer

Although Trump appears to be more “drill-friendly” than the more environmentally conscious policies of Clinton, current regulations have not been too restrictive. Hence, a new wave of investment decisions augmenting domestic oil production is unlikely.

Overall, the difference between a Clinton and a Trump victory should not have very material consequences on oil production according to Deutsche Bank analyst Michael Hsueh. At the margin though, the de-regulation approach of Trump leaves more room for US production increases to dampen future oil prices rises.

#### EUR exchange rate: slight upside risk

The uncertainty associated with the policy outlook for the US economy could push the EUR up in the short-term. For example, the usual negative correlation of the euro with US equities is one reason for a EUR/USD rally on the back of a Trump victory near term.

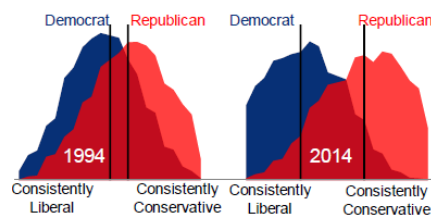
In the medium-run, the effect is ambiguous:

- *Arguments strengthening USD:* a big fiscal stimulus as observed in the early years of the Reagan administration, combined with higher rates and curve steepening would push the USD up. FX strategist Alan Ruskin thinks that this could have very favourable implications for FDI, the US narrow basic balance and ultimately the USD. But he also highlights that the market will rightly have some serious concerns about long-term fiscal sustainability and the longevity of stronger growth.
- *Arguments lowering USD:* The rise in stimulus would result in bigger current account deficits and the exchange rate premium would also push the USD down. Doubts about the willingness of the Chinese Central Bank to continue purchasing Treasuries could emerge. Especially so if the new US administration maintains a strong rhetoric on trade and currency manipulations accusations. Such developments could accentuate a risk-off scenario, turning the FED towards a more dovish stance.

## Trump, Brexit and a busy political calendar

Figure 3 reports the increasing polarization of voters' attitude that developed over the last 20 years in the US. Such a concentration of the electorate beliefs away from the centre and towards two different extremes illustrates well the developments of the US Presidential campaign. The strengthening of support from policies away from the centre and towards the extremes may also have played a role in the Brexit vote.

Figure 3: Polarisation of politics



Note: Republicans include Republican leaning independents, Democrats include Democratic leaning independents. Columns denote medians.  
Source: Pew Research, Deutsche Bank



In our view the overall lesson from Brexit and Trump's strong performance is that radical outcomes at national elections or in referenda have become a less farfetched possibility. Note that the UK and the US are in a significantly better position than several euro-area peripheral countries based on the economic indicators such as the recovery in GDP-per capita and the unemployment rate.

The next twelve months in the euro area are packed with political risk with elections in Germany, France, the Netherlands and Austria and the ongoing Brexit negotiations. Among these, Italy's referendum on the senate reform on 4 December is the most complex to analyse and potentially the most important for euro-area stability (see [Focus Europe](#) on 21 October).

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## Conclusions

The above described financial developments could partially hinder the transmission of the ECB's monetary policy.

Furthermore, with the "risk" outcomes having materialised in the UK referendum and in the US Presidential elections, we expect increasing apprehension about the various political events coming up in Europe over the next twelve months. This uncertainty will constrain the euro-area recovery via both real and financial channels. It underscores our expectation that euro-area GDP will slow in 2017. A slowdown in the already mediocre euro-area recovery will further complicate the ECB task.



# Appendix 1

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