Box I.1.2: Spillovers to the EU from US tariffs imposed on third countries – model-based simulations

Tariffs on US imports from non-EU trading partners could indirectly affect the EU economy. Beyond the effect of US tariffs imposed directly on EU-produced goods, US tariffs targeting *other* countries could also generate spillovers to the EU economy – a channel referred to as *trade diversion* hereafter. This box analyses the effects of such trade diversion on the EU, based on simulations with the European Commission's QUEST model [1].

The analysis in this Box examines the impact of trade diversion in isolation. For reference, Graph 1 reports the impact of the full US tariff package on the EU economy (solid lines), including both the direct effects of tariffs targeting EU-produced goods and the spillovers from trade diversion. The remainder of the exercise focuses on a unilateral increase in US import duties levied on non-EU countries *only* (dashed lines in Graph 1), so as to examine the impact of trade diversion in isolation and does so without considering other factors at play. For instance, the observed dollar depreciation (rather than the appreciation implied by tariffs in isolation) points to additional factors such as declining investor confidence and rising US risk premia. Likewise, pre-existing concerns such as Chinese firms seeking to export their excess production in specific sectors pre-date the tariff announcements and are outside the scope of this analysis. In so doing, the analysis illustrates specific mechanisms at work, rather than predicting outcomes. This is an important caveat for the interpretation of the results.

Trade diversion operates through changes in international relative prices and weakening global demand. As a starting point, we consider a scenario with producer currency pricing (PCP), where exporters set prices in their own currency and adjust them only gradually. US tariffs on non-EU trading partners (blue dashed lines) alter the relative prices faced by EU firms in various markets. On the one hand, these tariffs generate a terms-of-trade depreciation in third countries, as US demand for their products weakens, making them cheaper. This hurts the competitiveness of EU firms vis-a-vis these countries, which is reflected in the strengthening of the EU's effective terms-of-trade. As a result, EU imports from third countries increase, while EU exports to the rest of the world decline. On the other hand, *after-tax* relative prices within the US market change *in favour* of (non-tariffed) EU producers against tariff-hit third country competitors, supporting EU exports to the US. Therefore, even though EU exporters lose competitiveness globally due to a stronger terms-of-trade, they gain market share in the US due to the selective tariff treatment of others. Beyond the effect of relative prices (expenditure *switching*), the global downturn induced by the tariffs weakens import demand across all trading partners, further weighing on EU exports (expenditure *changing*).

On balance, US tariffs on third countries inflict short-term economic losses on the EU, but can have a beneficial impact in the longer term. In the short run, the negative spillovers dominate, with trade diversion *amplifying* the decline in EU net exports and real GDP generated by the direct effects of US tariffs on EU goods. Over time, however, as market shares in the US gradually increase, the impact of trade diversion turns positive, thereby *mitigating* the adverse economic consequences for the EU. In case EU market share gains in the US materialize faster than assumed in the model, this could also make the short-term effect more benign.

Trade diversion reduces EU consumer prices and generates a terms-of-trade gain. The short-term recessionary effects of trade diversion lead to slack in the EU economy, generating domestic disinflationary pressures. In addition, import prices also decline, stemming from a stronger nominal effective exchange rate and falling foreign export prices. The euro strengthens on a trade-weighted basis despite weakening vis-a-vis the US dollar - the currency of the tariff-imposing country - since the latter effect is outweighed by the nominal depreciation of tariff-hit third countries, which constitute

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[1] QUEST is a New Keynesian open economy dynamic stochastic general equilibrium (DSGE) model, featuring trade also in intermediate inputs, thereby capturing linkages through cross-border value chains, which amplifies the effects of trade barriers. For these simulations we use a 6-region version of the model, including the EU, US, China, Canada, Mexico and the rest of the world (RoW), whose trade linkages are calibrated based on the FIGARO database. More details about the model and other tariff scenarios can be found in: Motyovszki, Gergő (2025). The macroeconomic effect of US tariff hikes. *ECFIN Discussion Papers*, (forthcoming).
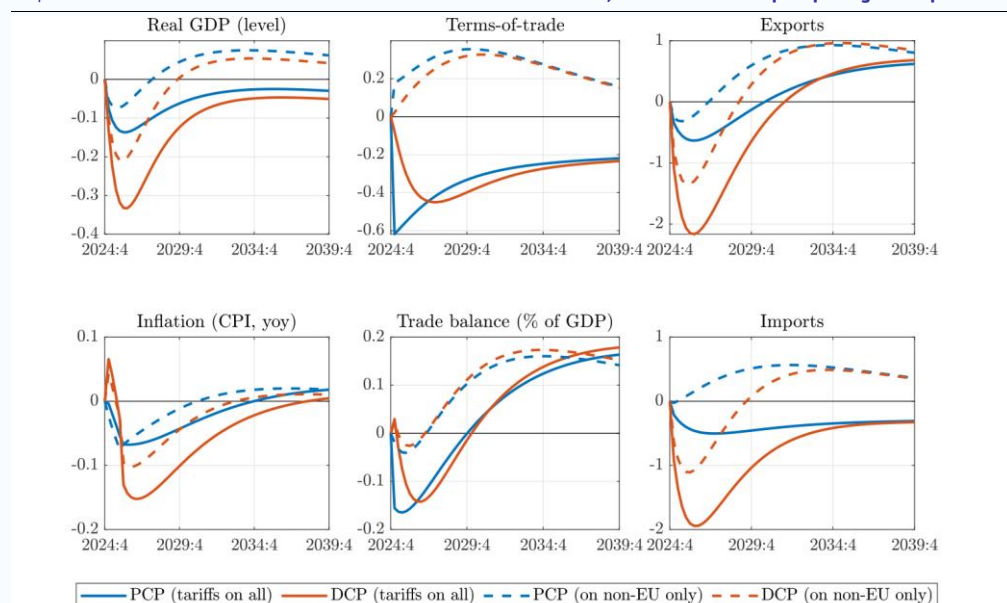
Box (continued)

a larger share in EU trade flows. The tariff-induced decline in the external demand of these countries gradually exerts downward pressure on their export prices. Lower import prices for the EU raise the purchasing power of European consumers, and contribute to higher real incomes.

In an alternative scenario, dominant currency pricing hinders international relative price adjustments, leading to sharper declines in global trade and GDP. Motivated by the dominant role of the dollar in global trade invoicing, we also explore a scenario with dominant currency pricing (DCP). [2] Under DCP, export prices are set in the same currency (US dollar) across the world. Therefore, movements in (flexible) nominal exchange rates have less influence on the terms-of-trade. This limits the extent to which relative prices can adjust to offset the trade-reducing impact of tariffs, thereby weighing more on global economic activity (see red vs blue solid lines in Graph 1

With trade invoicing in dollars, the spillovers from trade diversion are more detrimental to the EU, owing to a stronger global downturn. By constraining terms-of-trade adjustments, DCP weakens expenditure *switching* in driving trade diversion (see dashed lines in Graph 1). In contrast, expenditure *changing* becomes more important. As the deeper tariff-induced global recession reduces import demand from third countries, EU exports are lower than under PCP, despite a smaller terms-of-trade appreciation. The weaker export performance also weighs on EU GDP, reducing import demand to such an extent that imports *decline* – despite the EU's terms-of-trade still appreciating. This contrasts with PCP (blue dashed line), where trade diversion was reflected in *higher* imports from tariff-hit third countries.

Graph 1: **The macroeconomic effects on the EU from US tariff hikes, under different export pricing assumptions**

Notes: In response to unilateral US tariff hikes, lines depict %-deviation of levels from a no-tariff baseline. For CPI inflation and the trade balance, lines depict percentage point deviations. Export prices follow either producer currency pricing (PCP, blue lines), or dominant currency pricing in US dollars (DCP, red lines). Solid lines capture the effects on the EU of unilateral US tariff hikes on all trading partners, while dashed lines isolate the effect on the EU stemming from US tariff hikes levied only on imports from third (non-EU) countries, i.e. the trade diversion effects.
Source: European Commission services.

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[2]   As an illustrative (extreme) assumption, the DCP scenario assumes universal use of the US dollar in global trade. Empirically, the euro is the most used currency for extra-EU trade invoicing on the export side (with a share of 51.7%), but it is closely followed by the US dollar (31.4%). See Eurostat (2025). In addition, the dollar is a more relevant invoicing currency for the exports of third countries, the spillovers from where we are interested in.