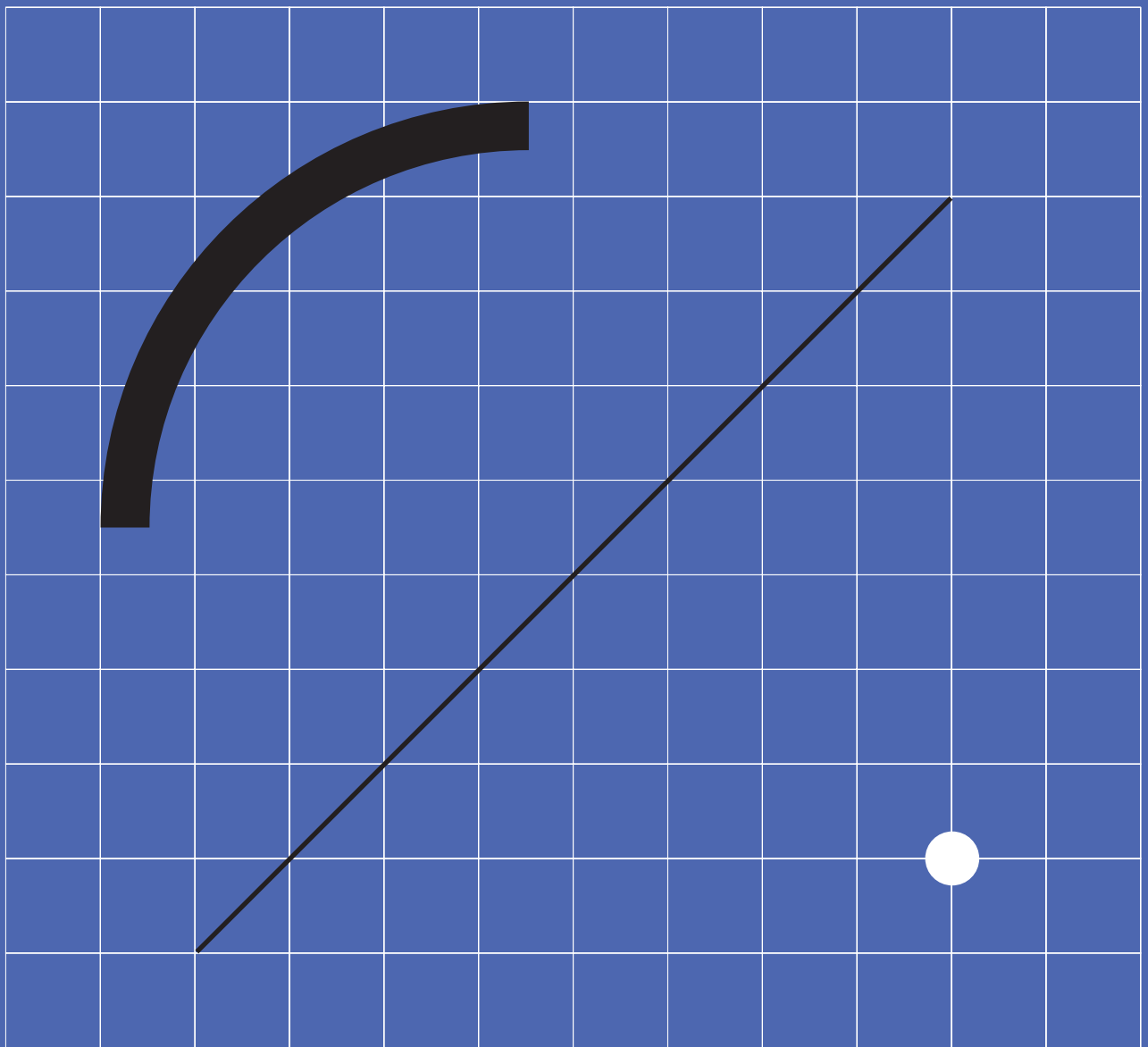


How Should Europe Respond to King Donald?

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How Should Europe Respond to King Donald?

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With Europe—and others—granted 90 days to negotiate a new “deal” with Donald Trump that avoids the threatened reciprocal tariffs, everyone is rethinking their playbook for managing the mercurial U.S. President.

No one, American or not, can offer great advice on how to handle Europe’s newly belligerent partner to the West. But those Americans who still believe that America’s traditional allies are an asset can try.

This essay proposes five broad principles for Europe’s collective response, all of which would preserve the basis for a strong future economic and security partnership should American politics change.

The standard diplomatic playbook for “managing” Donald Trump was heavily inspired by the example set by Japan’s former Prime Minister Shinzo Abe. He had the advantage of a good golf game, but knew enough not to try to beat the President. He understood that the flattery should flow copiously when the TV cameras are on. More controversially, Abe was willing to absorb a few punches without punching back. Abe didn’t file a WTO challenge, let alone retaliate against U.S. steel tariffs. Trump also no doubt appreciated Abe’s willingness to strike a trade “mini deal” that gave U.S. farmers many if not most of the concessions that were negotiated in the Trans-Pacific Partnership without requiring the U.S. to open its market to Japanese auto imports.

Diplomats in Washington took note; the playbook for managing Trump has been to keep a direct line to the President, be unsparing in flattery for his genius, and offer cosmetic concessions for Donald Trump to sell. But there are clear limits to just how much President Trump can be managed. No one has—not former German Chancellor Angela Merkel, not former Goldman Sachs executive Gary Cohn, not former Senate leader Mitch McConnell—has been able to shake Trump of his core belief that America’s allies have long exploited their economic relationship with the United States and that high and broad tariffs on America’s friends are a necessary corrective. Japan was never really rewarded for Abe’s skill at building a personal relationship with Trump. Japan’s steel exports to the U.S. never recovered from the initial round of tariffs, and it now faces a brutal 25 percent tariffs on its critical auto exports. Its “reciprocal” tariff was higher than the threatened tariff on the EU.

The EU now faces a major choice. With the 90-day clock on reciprocal tariffs ticking, no major U.S. trading partner can afford not to engage in a bit of diplomacy with President Trump. But they equally cannot manage their economies on the assumption that diplomacy will succeed, given Trump’s clear determination to tear up the old rules of global trade.

The same broad challenge arises over other issues in the transatlantic relationship: Trump’s advisors know that it is hard to keep Trump from being Trump. A NATO discussion with the U.S. over European defense spending and the purchase of additional U.S. arms is very possible; a G7 discussion over Trump’s (absurd) determination to incorporate Greenland’s melting glaciers into the U.S. probably wouldn’t go very far.

No one, American or not, can offer great advice on how to handle Europe’s newly belligerent partner to the West. But those Americans who still believe that America’s traditional allies are an asset can try.

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DRAGHI, WITH A BIT OF DELORS

The U.S. trade deficit has long supplied Europe with an important source of demand for its output of manufactures. Exports to the U.S. are now close to three times exports to China – even excluding tax driven trade in pharmaceuticals, exports to the US are two times those to China. That kind of demand is hard to replace in today’s world.

Trade diplomats sometimes suggest that new trade agreements with countries like India can keep the flame of liberal trade alive even as the U.S. retreats. Perhaps, but it is hard to run an economy on the moral satisfaction created by setting a good example. India, a \$4 trillion economy, isn’t going to start importing more than €500 billion in European goods. Flirting with an opening toward China may be an appealing diplomatic play, but China, like Europe, is a net source of supply of manufactures to the global economy. What Europe needs is to replace is the demand that came from the U.S., not demand displacement from Chinese imports.

For an economy of Europe’s size, the real alternative to the U.S. market, as Mario Draghi made clear in his recent report, is a stronger internal European market.

The good news is that Europe is in a better position than many realize. Exports to the U.S. are something like 3 percent of European GDP—a big sum, but nothing that can be replaced more easily than Canada’s roughly 20 percent of GDP in exports to the United States. Moreover, Europe’s goods trade, properly assessed, is also close to balanced: take out Ireland’s €100 billion surplus in pharmaceuticals and chemicals (an artifact of transfer pricing that reflects only a tiny amount of real activity) and Europe’s global goods surplus falls to around €50 billion. Europe already relies on global demand much less than say China.

Moreover, Europe has the fiscal space needed to respond

to a clear exogenous shock. Euro-pessimists like to highlight that national fiscal space is unevenly distributed across the European Union. But that is less of a concern now, when most of the economies most exposed to trade and the Russian shock also have substantial fiscal space. Germany, the Netherlands, Denmark, Sweden, and yes, Ireland, all have plenty of scope to increase their own borrowing. Moreover, as Draghi emphasized in his report, the EU collectively can also borrow at low rates to achieve common European goals. Europe's fiscal metrics are better than those of the United States, yet Europe often acts as if only the U.S. has policy space.

Common European borrowing is politically difficult, but an unprecedented U.S. President calls for an unprecedented European response. Common defense bonds, for example, can help to share the defense spending bill across Member States, avoid free-riding by Spain on the effort provided by the spending of countries like Poland, and assure more efficient joint procurement of defense kits. To paraphrase an American phrase, Europe working together can get more bang for its euro.

Draghi's call for integration, though, should be married with the hard-nosed "European" nationalism personified by former French Commission President Jacques Delors.

In the face of a new China shock, Europe has every incentive to try to hold on to its own demand. Draghi recognizes this in his call to deploy 'buy-European' local content requirements for sectors that are strategically important or employment rich. The Commission and some traditional pro-trade Member States fret about any deviation from WTO orthodoxy. But there is a long European tradition of thinking that Europe's own market should not so easily be shared with the rest of the world, which fits well with today's more brutal world economy.

DON'T ALWAYS TURN A CHEEK, BUT DON'T THROW RECKLESS PUNCHES

President Xi Jinping famously told a group of visiting business executives back in 2018 that in Western culture, a punch would be met by turning the cheek—while China's culture was always to punch back. Xi's command of Western culture wouldn't survive a pub brawl, but his basic instinct to punch back unfortunately does have some merit. Without retaliation, any negotiation will only be about rolling back a portion of the new U.S. tariffs for changes in long-standing European policies. That

is unbalanced. Europe should aim for a standard trade truce in which both parties de-escalate by withdrawing new tariffs while negotiating on the harder issues.

But the need to retaliate is not a reason to respond recklessly.

The EU should not respond dollar-for-dollar or euro-for-euro to the U.S. tariffs, which would require imposing even higher tariff rates than the U.S. given the discrepancy in measured goods trade. A dollar-for-dollar response would require that Europe take actions that impose disproportionate costs on its own economy. Tariffs on certain key inputs—like U.S. natural gas—would only raise the price of gas in Europe.

The sensible response would be one that aims for symmetry in the trade action, not symmetry in impact.

What does this mean? Rather than matching tariffs on \$20 billion worth of EU imports with counter-tariffs on \$20 billion of U.S. exports, Europe should match sectoral tariffs with equal sectoral tariffs. Auto tariffs would be met with auto tariffs, pharmaceutical tariffs would be met by pharmaceutical tariffs, and so on.

This more measured response would still have an impact on the U.S., as it exports around \$20 billion in autos to the EU and roughly \$50 billion in pharmaceuticals. Indeed, if the EU wanted to signal a desire to de-escalate, the 25 percent U.S. auto tariff (which raises the overall tariff to 27.5 percent) could be met by a 17.5 percent tariff, which would match the U.S. tariff rate.

Similarly, a 10 percent "base" tariff could be met with a 10 percent tariff (with exclusions where the exclusions serve European interest).

Such a response appears reciprocal, using the conventional definition of reciprocal. It additionally reserves Europe's heavy trade artillery—the anti-coercion tool and possible taxes on U.S. digital platforms and other "service" exporters—for any U.S. measure that crosses the line into unambiguous economic coercion.

DON'T BE NAÏVE

The EU should have the confidence that it has the fiscal strength and trade tools needed to hold its own with the United States. It shouldn't rush into deals that are damaging and naïve.

To start, the EU should not give into the Trump administration's demand that it reduces its value-added tax. Dropping non-discriminatory VAT, which applies equally to imports and products built in the EU, when Europe needs to spend more on defense would be worse than naïve—it would be reckless.

There is another example: EU policymakers have floated dropping Europe's auto tariff entirely on all countries in response to Trump's criticism of the 10 percent current rate. That would be naïve. Opening Europe's markets to China unilaterally wouldn't solve European exporters' problems in China. It also wouldn't help Washington. The U.S. does not want to open Europe's market to Chinese auto exports. It wants better access for American exports.

The only reason not to cut the tariff for the U.S. only (and keep it for China) is to fit cleanly into the WTO's rules. That is naïve at a time when the U.S. openly ignores WTO rules and China ignores them in practice.

PLAY TO TRUMP'S PREJUDICES

Trump really wants balanced trade, not just equal tariffs. There are relatively painless ways for Europe to help the U.S. achieve that goal.

Remember that the United States' biggest measured bilateral trade deficit with any EU country is now with Ireland. That is almost all pharmaceuticals, and for that matter, almost all pharmaceuticals produced in Ireland by U.S. companies seeking to avoid paying the U.S. headline corporate tax rate. The \$100 billion that the U.S. imports from Ireland adds enormously to the United States bilateral trade deficit. It far exceeds the \$15 billion in LNG the U.S. now exports to Europe (down from a 2022 peak of \$30 billion) or the \$40 billion autos and auto parts the U.S. imports from Europe.

Simple math suggests that this should be the easiest part of European trade to bring into balance, as it is almost entirely a function of gaming the U.S. tax system. For example, a European top-up tax on pharmaceutical profits that raise the minimum rate on income booked in the EU to 20 percent would radically reduce Europe's measured trade surplus with the U.S. (as U.S. firms would reverse transfer pricing schemes that raise reported imports to shift profits to EU countries) while initially falling far more heavily on American, not European, firms. No doubt there are other ways to reduce profit shifting

incentives as well.

The basic point though is simple. Paul Krugman has noted that a significant fraction of U.S. imports from Europe are "fake" as they are imported at a price that is inflated by transfer pricing. The EU should be able to find a way to avoid being penalized for that fake surplus—and strike a blow against tax avoidance in the process.

SHOW THAT EUROPE HAS REAL CARDS TO PLAY

Europe's capacity to mount a credible defense of Greenland is limited by geography—and the size of the U.S. Atlantic fleet. France's carrier group cannot always be off Greenland's west coast. But European special forces could intensify their Arctic training and Europe's continental powers could do more to highlight their contribution to the joint NATO defense of the Arctic.

Europe though has an awful lot of cards to play in Ukraine. In fact, with enough political will, Europe could demonstrate that the path to peace in Ukraine runs through Berlin, Brussels, and Paris rather than through an increasingly disengaged DC.

Europe, collectively, could:

1. Provide the financial support Ukraine needs to keep its economy stable until there is a peace and then rebuild. The financial flows needed are in the range of €20-30 billion a year.
2. Provide financial support for Ukraine to buy the arms needed to sustain a defensive line that preserves Ukraine's independence—even if Russia will continue to occupy Eastern and southern territories. Not all those arms can currently come from Europe (though a series of "warp speed" operations to expand munitions production would help strengthen Europe's hand)—but Europe can provide funds to buy U.S. munitions for Ukraine.
3. Put economic pressure on Russia. The most powerful sanctions to date have all been European—as before 2022 Russia engaged in little trade with the U.S. and had put all its reserve assets in Europe. Tightening the oil and gas sanctions (ending LNG imports from Russia, for example) can be done by Europe on its own. The EU on its own could find more creative ways to use €190 billion in assets that are now held by Euroclear and the additional €50 billion in assets that have been immobilized and identified outside of Euroclear.
4. Provide the troops that would assure Ukraine's

security in any realistic deal.

U.S. satellite intelligence, airborne surveillance, shells and air defense missiles are all still needed in the short run. But Europe's combined military and diplomatic and financial power is substantial, and outweighs the financial, diplomatic, or military support that Trump is willing to deploy to support Ukraine or pressure Russia.

If the world divides into spheres of influence, Ukraine may not fit well into the "American" sphere. Yet if given the constellation of economic and military forces now available in Europe, it still fits more naturally into the European sphere than the Russian sphere. That outcome would respect the democratic aspirations of Ukraine and the reality that the EU's economy is 10 times Russia's economy.

CONCLUSION

Europe has a strong hand to play in the coming years. The steps needed to insulate Europe's economy against Trump are also fundamentally in Europe's own interest. If a future U.S. president wants to reinvigorate the transatlantic partnership, these steps would also lay the foundation for a balanced economic and military alliance. They also should be welcomed by the many Americans who aren't sold on Trump's vision of an America that severs its ties with its long-standing allies in pursuit of an unlikely accord with the autocratic leaders President Trump seems to admire.

The U.S. would benefit from a bit of tough love, and a European partner that stands up for itself.