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(Customs) unity as strength: How the EU and its partners can respond to tariff threats

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This Policy Brief explores the potential impact of forming a customs union between the European Union (EU) and key global partners (e.g. Canada, the UK, Mexico and Japan) as a strategic response to U.S. President Donald Trump's threatened tariffs. Using the GSIM partial equilibrium model, the study simulates various customs union configurations under two baseline scenarios of high and low U.S. tariffs. The findings show modest overall economic effects, with the EU consistently benefiting from increased output, while countries like Canada, Mexico and Japan would also gain under certain scenarios. The U.S. would experience output losses, and China would incur consistent welfare losses. The study argues that, beyond the economic rationale, broader security and geopolitical concerns – especially in light of Trump's antagonism towards NATO and traditional U.S. allies – justify stronger EU-led economic cooperation. It advocates for a strategic expansion of the EU's customs union to include like-minded global partners, reinforcing trade resilience and global economic stability.

1. Introduction

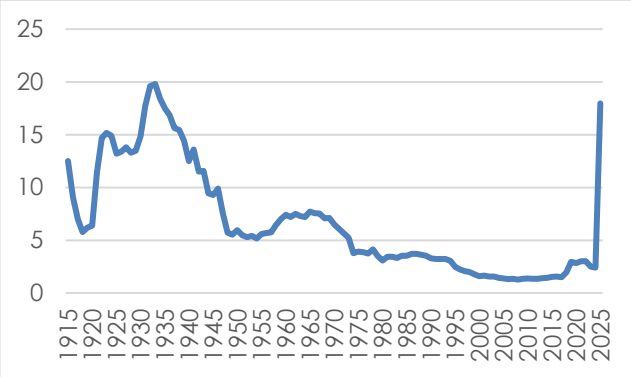
On 2 April 2025 – his self-proclaimed "Liberation Day" – U.S. President Donald Trump announced a new round of tariffs. This time, all U.S. trade partners will face a minimum "discounted reciprocal tariff" of 10%. For countries with trade surpluses accused of "currency manipulation and trade barriers", tariffs could rise to as much as half the percentage of their surplus relative to their exports to the U.S., reaching nearly 50% in some cases. The export-driven economies of Southeast Asia would be particularly affected. Major partners, such as the EU (20%) and Japan (24%), could face intermediate rates, although these remain extremely high by historical standards. In the case of China, which opted for strong retaliatory measures, U.S. tariffs have escalated to approximately 145%. The UK and several other countries will be subject to the baseline 10% tariff. For Canada and Mexico, the situation is more complex, as earlier fentanyl- and migration-related tariffs may remain in place.

Overall, the situation remains confusing, as various exemptions have been introduced – for instance, on goods already targeted earlier (e.g. steel, aluminium and cars) as well as on copper, pharmaceuticals, semiconductors, lumber, energy imports and certain minerals not available in the U.S. Since 2 April, additional goods, including products that contain semiconductors (e.g. smartphones) and other consumer electronics, have been exempted from the new tariffs. To stay up to date, one can consult a trade war timeline, such as that maintained by the Peterson Institute for International Economics. Most importantly, on 9 April, Trump amended Executive Order 14257 of 2 April, pausing the differential tariffs on trade surplus countries for 90 days while maintaining the 10% tariff on nearly all countries. Due to its strong retaliation, China will continue facing prohibitive higher tariffs. This reflects the situation as of the end of April 2025.

Trump has been obsessed with tariffs since at least the 1980s, when Japan's economy grew stronger. During his first administration, Trump already implemented a series of protectionist trade measures targeting multiple countries, most notably China. In January 2018, he imposed tariffs of 30-50% on solar panels and washing machines. This was followed in March by 25% tariffs on steel and 10% on aluminium, initially affecting most countries and covering over 4% of U.S. imports. By June, these tariffs had been extended to the EU, Canada and Mexico. Separately, escalating tariffs on Chinese imports triggered retaliatory measures, particularly on critical raw materials vital for chip and battery production.

Trump has effectively ended decades of U.S. advocacy for free trade. While some trade barriers had already been introduced during the administration of U.S. President Barack Obama, the current radical tariff hikes draw comparisons to the last U.S.-led global trade war, waged by three consecutive Republican presidents – Warren G. Harding, Calvin Coolidge and Herbert Hoover – who governed from 1921 to 1933. The Emergency Tariff of 1921 responded to collapsing agricultural prices after the First World War, followed by the Smoot-Hawley Tariff Act of 1930 (Mitchener et al. 2022), which raised U.S. average effective tariff rates to 20% (Figure 1). These restrictions provoked a global trade war, which, combined with the Great Depression, arguably contributed to the rise of fascism in Europe and Asia.

Figure 1: U.S. average effective tariff rate, 1915-2025, in %



Source: The Budget Lab at Yale, 15 April 2025.

2. Simulating the "reciprocal" tariff world

How will the "reciprocal" tariffs announced on "Liberation Day" impact the global economy? And what would be the effects of potential (coordinated) responses to the threatened tariffs? While general equilibrium trade models typically forecast modest long-term effects as economies gradually adjust, partial equilibrium models are better suited to capturing the immediate, disruptive impacts of tariff hikes, as they largely overlook second-round effects. To assess these short- to medium-term consequences, we apply the partial equilibrium Global Simulation Model (GSIM) developed by Francois and Hall (2002) and employed – for example, by Holzner (2008) and Holzner and Ivanić (2012) – to the current situation, focusing on the U.S., Canada, Mexico, China, Japan, the UK, the EU, and the rest of the world.

In our model, goods trade flows are based on UN COMTRADE 2023 import and export data in USD. Domestic trade is approximated using 2023 GDP data from the World Development Indicators (WDI) database. Initial tariff rates are taken from the 2022 ad valorem simple average rates in the World Integrated Trade Solution (WITS) database. To ensure a conservative estimation of trade effects, we apply a composite demand elasticity of -0.5, an industry supply elasticity of 0.6, and an elasticity of substitution of 2.0 along half of their lower bound values in earlier research (Vukšić and Holzner 2016).

Which tariff war scenarios should be considered and compared, and which (coordinated) responses by U.S. trade partners should be simulated? As the announced and implemented tariff rates are changing almost daily, we are forced to make some assumptions regarding the short to medium term. Based on Trump's "Liberation Day" announcements, we know his minimum tariff rate is 10%. His upper limit appears to be the percentage of a country's trade surplus relative to its exports to the U.S., which he considers "fair" for balancing U.S. goods trade. Accordingly, our lower baseline scenario assumes a uniform 10% U.S. tariff on all trade partners, while our upper baseline scenario applies the full "reciprocal" rate for trade surplus countries (disregarding further escalated rates for China) and 10% for all others. No retaliation is assumed.

But how should countries respond to Trump's tariffs? Is it better to retaliate or just take it? Particularly for smaller countries, retaliation through import tariffs is not the best response from a game-theoretical perspective, although limited, targeted retaliation may be unavoidable for domestic political reasons (Rodrik 2025). Another option is to strengthen trade relationships that exclude the U.S. by forging new trade agreements (Cohen 2025). This approach aligns with the spirit of the Draghi (2024) report, *The Future of European Competitiveness*, which advocates for greater coordination and cooperation rather than relying on mercantilist trade surplus strategies.

We propose two coordinated response scenarios involving the EU and several of its major democratically governed global partners. In the first, the EU forms a customs union with the UK and Canada. In the second, this customs union is expanded to include Japan and Mexico. This would imply a deepening of already existing or recently adopted trade agreements with the EU. These alliances would account for roughly a quarter and a third of global exports, respectively. The partners would adopt the EU's external tariffs, and other countries would treat the new blocs as they had previously treated the EU. Trump would apply his "reciprocal" tariffs. Again, no retaliation is assumed.

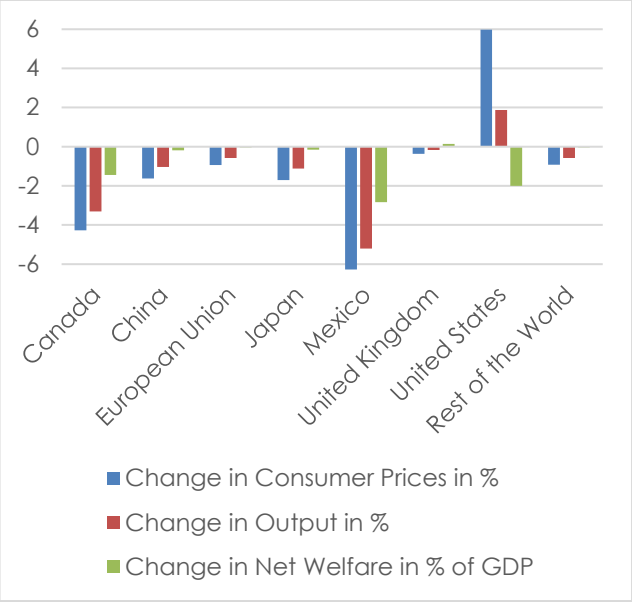
3. The potential gains of unity

3.1 The baseline scenarios

In the upper baseline scenario, where Trump's full "reciprocal" tariffs are introduced without any "discount" (i.e. for trade surplus countries double the tariffs announced on 2 April 2025 and 10% for the others), almost all countries experience a decline in net welfare (Figure 2), measured by the combined effects on producer surplus, consumer surplus and tariff revenue. In the U.S., inflation would likely surge by around 6% (similar to other estimates), while output could rise by 2%. However, the gains for producers and the federal budget would be insufficient to offset the losses for consumers, resulting in a net welfare decline of about 2% of GDP.

Conversely, U.S. trade partners would experience falling prices, as some goods originally intended for export to the U.S. are redirected to local or regional markets. Output would also decline. In terms of net welfare loss as a share of GDP, the most affected economies would be Mexico (-2.8%) and Canada (-1.4%), given their significant trade surpluses with the U.S. The EU could see inflation fall by almost 1%, with a 0.6% decline in output, while net welfare effects would be broadly balanced. The impacts on Japan and China would be somewhat greater, and those on the UK and the rest of the world somewhat smaller. However, in times of low growth, even a tenth of a percentage point can make a significant difference.

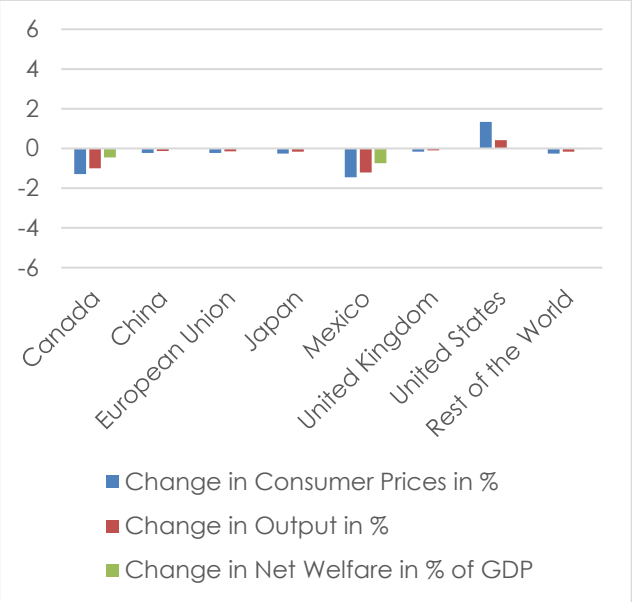
Figure 2: Simulated trade war effects in terms of inflation, output and net welfare, upper baseline scenario



Source: Own calculations using the partial equilibrium GSIM model.

The lower baseline scenario, in which all U.S. trade partners "only" face a 10% tariff rate, predictably results in much smaller effects (Figure 3). Still, Mexico and Canada would be hit hardest, each losing about half a percentage point of GDP in net welfare. The EU and other partners would see output declines of one to two tenths of a percentage point, along with roughly double that decrease in consumer prices, with mostly balanced net welfare effects. In the U.S., consumer losses and producer and budget gains would roughly offset each other. Nevertheless, exports to the U.S. would drop by double digits, causing significant pain for export-oriented industries worldwide and triggering structural adjustment costs that are typically unevenly distributed.

Figure 3: Simulated trade war effects in terms of inflation, output and net welfare, lower baseline scenario



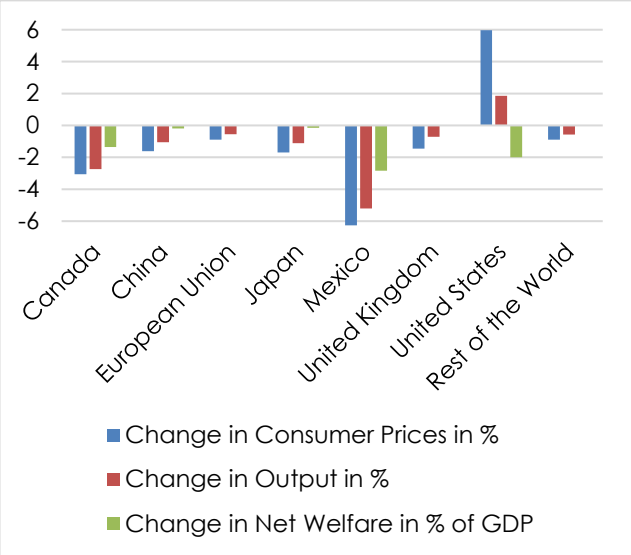
Source: Own calculations using the partial equilibrium GSIM model.

3.2 The cooperation scenarios

The first cooperation scenario assumes zero tariffs between the EU, Canada and the UK, with the latter two also adopting EU external tariffs and being treated by other countries as part of the EU. Meanwhile, the U.S. applies its upper "reciprocal" tariffs. Most of the results (Figure 4) are similar to those in the baseline scenario (Figure 2). However, Canada now experiences about one percentage point less deflation and half a percentage point less output loss. Interestingly, under the customs union, the UK (not being a trade surplus country) faces slightly stronger deflation and output losses, as in the baseline scenarios. Again, these largely offset each other in terms of net welfare effects.

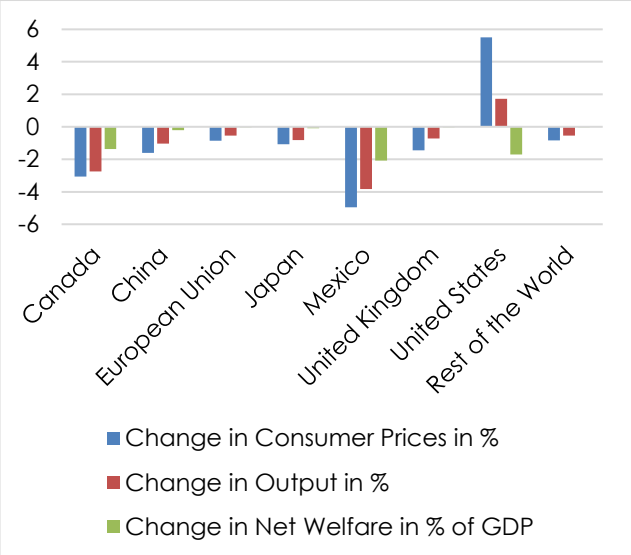
In the extended cooperation scenario, where Japan and Mexico join the customs union with Canada, the EU and the UK, the trade surplus economies would again benefit from lower output losses (Figure 5). In particular, Mexico would see a marked improvement in its net welfare position, as gains from access to a larger market would partly offset the loss of a part of the U.S. market and lower tariffs for exports to the U.S. would apply. For the EU, the economic impact would be negligible. However, the expanded market would likely hold even greater leverage in future trade negotiations.

Figure 4: Simulated trade war effects in terms of inflation, output and net welfare, upper CA-EU-UK cooperation scenario



Source: Own calculations using the partial equilibrium GSIM model.

Figure 5: Simulated trade war effects in terms of inflation, output and net welfare, upper CA-EU-JP-MX-UK cooperation scenario



Source: Own calculations using the partial equilibrium GSIM model.

We do not present the two cooperation scenarios under the lower "reciprocal" tariff setting graphically, as the direction of the effects would be similar to those described above. The key difference is that the magnitude of the impacts would be much smaller, given that the U.S. would raise tariffs only to 10% under the lower baseline scenario.

3.3 Cooperation and baseline scenarios in comparison

Finally, in the following section, we compare the two cooperation scenarios with the two baseline scenarios in more detail. Tables 1–4 present the corresponding percentage point differences between the scenarios in terms of changes in the inflation rate, output growth and net welfare as a share of GDP.

Table 1: Difference between the upper baseline and the upper CA-EU-UK scenario

	Δ inflation, pp	Δ output, pp	Δ welfare, pp GDP
Canada	1.21	0.57	0.08
China	-0.01	-0.01	-0.01
European Union	0.05	0.04	0.02
Japan	0.01	0.01	0.00
Mexico	0.01	0.01	0.00
United Kingdom	-1.09	-0.56	-0.16
United States	-0.02	-0.02	0.00
Rest of the World	0.03	0.01	0.01

Source: Own calculations.

Table 2: Difference between the upper baseline and the upper CA-EU-JP-MX-UK scenario

	Δ inflation, pp	Δ output, pp	Δ welfare, pp GDP
Canada	1.20	0.56	0.07
China	0.01	0.00	-0.02
European Union	0.07	0.05	0.02
Japan	0.64	0.31	0.06
Mexico	1.31	1.38	0.76
United Kingdom	-1.08	-0.55	-0.17
United States	-0.47	-0.16	0.29
Rest of the World	0.09	0.04	0.01

Source: Own calculations.

As indicated above, countries with a trade surplus with the U.S. would benefit from joining a customs union with

the EU, as they would likely face lower tariffs under the upper "reciprocal" tariff scenario for exports to the U.S. (Tables 1–2). The UK, which due to its trade deficit with the U.S. is subject to only a 10% tariff, would experience a slight net welfare loss from joining a customs union with the EU and other surplus countries – likely less than two tenths of a percentage point. While UK consumers would benefit from lower prices, producers would lose out more, as production would decline by about half a percentage point. Interestingly, in the extended customs union scenario, even the U.S. would see a small net welfare gain, as it would harm itself less through higher tariffs, particularly against Mexico (Table 2).

Table 3: Difference between the lower baseline and the lower CA-EU-UK scenario

	Δ inflation, pp	Δ output, pp	Δ welfare, pp GDP
Canada	0.68	0.18	0.01
China	-0.01	-0.01	-0.01
European Union	0.06	0.04	0.01
Japan	0.01	0.01	0.00
Mexico	0.00	0.01	0.01
United Kingdom	-0.75	-0.29	-0.09
United States	-0.04	-0.03	-0.01
Rest of the World	0.04	0.02	0.00

Source: Own calculations.

Table 4: Difference between the lower baseline and the lower CA-EU-JP-MX-UK scenario

	Δ inflation, pp	Δ output, pp	Δ welfare, pp GDP
Canada	0.69	0.19	0.03
China	-0.01	-0.01	-0.01
European Union	0.08	0.06	0.02
Japan	0.05	-0.11	-0.05
Mexico	-0.79	-0.35	-0.12
United Kingdom	-0.74	-0.29	-0.09
United States	-0.04	-0.03	0.00
Rest of the World	0.09	0.04	0.01

Source: Own calculations.

Under the lower tariff scenario (i.e. a uniform 10% U.S. tariff), the comparison between the cooperative and baseline scenarios reveals only minimal differences (Tables 3–4). The direction of most effects mirrors those seen under the higher tariff scenarios. However, in the case of the extended customs union, both Mexico and Japan would experience a slight decline in net welfare. This is partly due to higher tariffs imposed on the EU by countries like China and other global trading partners.

Overall, it is noteworthy that under all cooperation scenarios, the EU would experience a modest net welfare gain. This improvement is primarily driven by increased output resulting from the expansion of the customs union's internal market – particularly through the resumption of exports to the UK. Conversely, in all scenarios, China would see a slight decline in net welfare compared to the baseline due to facing additional trade barriers from the newly formed customs union. However, these negative effects would be minimal.

Depending on the scenario, the U.S. would experience varying changes in net welfare. However, one effect remains consistent across all scenarios: U.S. output would decline following the establishment of an EU customs union with other major trade partners. While the magnitude of this impact is relatively small, it is a persistent and uniform outcome.

4. Conclusions

The simulation exercise above (using the partial equilibrium GSIM model) illustrated the potential effects of a customs union between the EU and major global trade partners. This represents one possible strategy for the EU and its allies to counter U.S. President Donald Trump's ongoing tariff threats. It would also complement a number of ongoing trade agreement negotiations and ratifications with other trade partners, such as India or the Southern Common Market Mercosur. The two baseline scenarios outline a likely maximum range for future tariff rates. In the upper baseline, tariffs are linked to each country's bilateral trade surplus with the U.S., typically ranging from 30% to 60%. Meanwhile, countries like the UK, which run trade deficits with the US, are expected to face a uniform 10% tariff, as assumed in the lower baseline scenario for all U.S. trading partners. For trade surplus economies, a tariff rate somewhere between these levels is likely to be the eventual outcome.

We simulated the creation of a smaller customs union between the EU, Canada and the UK, as well as an extended version that also includes Mexico and Japan. In all scenarios – when compared to the baseline – Canada would benefit, while the UK would experience modest net welfare losses. However, these overall effects remain relatively small. For Mexico and Japan, joining the customs union would be particularly advantageous under a high-tariff scenario and less so under the low-tariff scenario. The simulation is based on

the assumption that countries joining the customs union would adopt the EU's external tariffs against third countries, and that the U.S. would apply to all customs union members the same tariff rate it applies to the EU.

In all scenarios, the EU would benefit from the formation of a customs union, primarily due to increased output. China would consistently incur losses, while the U.S. would experience mixed outcomes depending on the specific scenario – but would face a decline in output across the board. Although the overall effects are modest, certain industries are likely to be significantly impacted. Moreover, given Trump's stronger emphasis on domestic production over consumer prices, he would likely perceive an EU-led customs union with global partners as a strategic threat.

A credible strategy to promote the expansion of a larger customs union centred around the EU should include mechanisms to compensate member countries facing sector-specific economic hardships. However, the formation of such a union cannot rely solely on the economic rationale. Given Trump's questioning of NATO's Article 5 commitment and even the sovereignty of long-standing allies, such as Canada, broader security considerations must also be factored in. Strengthening economic ties through a customs union can support not only security cooperation but also collaboration in areas such as research, innovation and technological development.

Trump's continued blackmailing of former allies should prompt political actors in EU member states to reconsider their frequent criticism of the EU and its supranational institutions. In this context, it is useful to follow the guiding principles outlined in Mario Draghi's (2024) report *The Future of European Competitiveness*. The report presents a comprehensive strategy to strengthen the European Union's global economic position. It emphasizes the need for a unified approach, pooled resources and improved coordination among member states. More – not less – cooperation is essential. In the area of trade policy, Draghi recommends securing preferential trade agreements with key partners and ensuring the resilience of critical supply chains.

Overall, the EU should be recognized as a collective insurance mechanism – particularly for smaller nations – against the coercive power of larger states and multinational corporations. Political representatives need to regularly inform the public about this essential function. This analysis aims to highlight some of the more ambitious, even utopian, policy options that require stronger political will and creative thinking. Such forward-thinking approaches must be applied at every level in light of today's formidable global challenges:

- **The EU common market perspective**: European unity must be demonstrated to the rest of the world by establishing a sizable EU budget and issuing a common safe asset, enabling joint investment in European public goods and fostering deeper integration of capital markets.
- **The EU extended enlargement perspective**: EU member states need to accelerate the enlargement process for current candidate countries, including Ukraine. Additionally, new potential candidates should be encouraged to join the process. Public support for EU membership is growing in several countries and territories, such as Iceland, Norway and Greenland.
- **The EU close partnership perspective**: In line with the preceding perspectives and the above analysis, the EU should invite key "like-minded" global partners – such as the UK, Canada, Japan and Mexico – to form a customs union as a coordinated response to ongoing U.S. tariff-escalation threats. Such a partnership could help jointly withstand trade pressures and serve as a stabilizing force for the global economy and political architecture.
- **The EU global neighbourhood perspective**: In the context of the ongoing Cold War 2.0 between the U.S. and China, the EU must broaden its concept of "neighbourhood" to a global scale rather than focusing solely on its immediate vicinity. Strengthening ties with emerging powers, such as India, as well as with countries across the Indo-Pacific and Africa, is essential for diversifying value chains and securing critical supplies.

While all of these perspectives must be addressed simultaneously, Trump's latest "reciprocal" tariffs demand immediate action. They risk re-enacting the misguided protectionist policies of the 1930s in a farcical yet dangerous way. This Policy Brief advocates for (customs) unity as a source of strength, urging the EU and its close global partners to respond to the renewed tariff threats in a coordinated manner.

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