The consequences of protectionism

Panel contribution by Benoît Cœuré, Member of the Executive Board of the ECB, at the 29th edition of the workshop "The Outlook for the Economy and Finance", "Villa d'Este", Cernobbio, 6 April 2018

In the two decades before the financial crisis, trade growth was a major contributor to higher living standards worldwide, with world imports growing at roughly twice the rate of output. The integration of many emerging economies into global trade, notably through participation in global value chains, boosted incomes and lifted millions of people out of poverty.

Since the crisis, however, trade has provided noticeably less support to economic growth. Trade growth has barely kept pace with output growth, and has even lagged behind it in a number of years. As a result, the current economic expansion in the euro area has been driven largely by domestic demand, supported by substantial monetary policy accommodation.

More recently, world trade has shown tentative signs of renewed vigour. Last year, world goods trade grew by more than 5%, the strongest rate for seven years, against less than 4% for world GDP. Yet, the nascent recovery in trade is at risk of being derailed by the introduction of impediments to global economic integration. There are signs that the anti-globalisation sentiment that has become more pervasive since the crisis has begun to be translated into actual policy measures.

Many commentators have expressed concerns that the tariffs recently announced by the US administration represent the first step towards a "trade war", potentially leading to a broader reversal of globalisation. Retaliatory measures have already been announced by some economies.
These steps are taken despite the benefit of trade for aggregate welfare being one of the rare points of consensus for economists. In a recent poll in which economists were asked whether the announced tariffs would improve Americans' welfare, the respondents were split between disagree and strongly disagree.[1]
At the same time, the benefits of globalisation have not been spread evenly, neither across nor within countries, something that economists have not given sufficient consideration for a long time. While textbook economics suggests that lump sum transfers from the winners of trade can ensure that all are better off, such transfers – or adequate training and educational measures – have not happened in sufficient scale to compensate everyone. According to a separate survey, only 40% of people in the United States think globalisation is a force for good for the world.[2]

Protectionism is not the right answer to these challenges, however. It is unlikely to solve the distributional consequences of globalisation while it is certain to reduce aggregate global living standards. There are no winners in trade wars, just different degrees of losers.
But to defend openness by listing its aggregate benefits is no longer fully convincing. The question of the distribution of those benefits and the disruptive effects that come with them has to be answered. Economists and policymakers therefore have a responsibility to propose and design policies that help those not benefiting directly from globalisation. I have previously spoken about the need to make globalisation efficient, enduring and equitable.[3]

Today I would like to share a central banker's perspective on potential structural changes to the current global trade regime – one where restrictions to trade are managed through multilateral agreements.

I would like to flag two main implications should impediments to the free movement of goods and services increase significantly. The first is the effects higher tariffs would have on growth and inflation in the near to medium term. There are a number of important channels to consider, including the direct impact of tariffs on prices and growth, changes to financial conditions and effects on expectations and confidence. The second main implication is the possible impact on long-run potential output growth, and how that may influence the conduct of monetary policy.

Implications for the short to medium term

Let me first look at the channels through which increases in tariffs may affect output and inflation in the short to medium term.

For illustration, I will use the results of simulations carried out by ECB staff using both the ECB's global model and the IMF's multi-country model. As with all models, the uncertainties involved mean precise estimates from these scenarios should be treated with caution, but they are useful to explain the different channels at work.

To illustrate the potential effects of rising protectionism, I do not want to dwell on the specifics of the tariffs currently being discussed. This would miss the bigger picture. I rather want to consider a hypothetical scenario where the United States raises tariffs on all imports of goods by 10 percentage points, and its trading partners impose the equivalent on US exports.

According to our model simulations, such a scenario would have significant adverse effects on the global economy, including, and in particular, on the economy that raises tariffs in the first place. Specifically, real economic activity in the United States could be up to 2½% lower than in the baseline in the first year alone. The reasons are essentially threefold:

- First, if domestic and imported goods cannot be easily and readily substituted, higher import prices increase firms' production costs and reduce households' purchasing power. These effects weigh on consumption, investment and employment, resulting in a material overall negative impact on GDP.
- Second, in addition to the direct adverse price effects, the uncertainty about growth prospects is likely to cause consumers to delay expenditure and businesses to postpone investment.[4] Much will depend on how consumers and businesses react, but ECB simulations suggest that such uncertainty and confidence effects could account for around one-third of the overall effect in the first year. In addition, financial investors react to uncertainty by selling equities, reducing credit and demanding higher compensation for risk. This in turn reduces wealth, increases the cost of investing and further discourages demand.
- And third, economic activity declines as US exports are hit by the tariffs abroad, which is only partially offset by lower imports.

In short, even though one may argue about the relative contributions of each of these channels, and the overall effect on economic activity, qualitatively the results are unambiguous: an economy

imposing a tariff which is retaliated by other countries would clearly be worse off. Its living standards would fall and jobs would be lost.

The effects on other economies would primarily depend on their size, trade openness and how much they trade with the tariff-imposing country. Naturally, the economies that have the closest trade relations with that country would be the most negatively affected.
But the effects could also be material for those economies that, despite having a less direct exposure, are particularly integrated into global value chains. For example, one estimate puts the share of global value chain-related trade at more than half of exports from many South East Asian economies.[5] The erection of trade barriers threatens this integration, with potentially serious negative consequences for those countries and probably for the global economy as a whole. Only a few open economies with little exposure to the tariff-imposing country may gain as a result of increased competitiveness in third markets.

In other words, the overall scenario is clearly a net negative for the world economy as a whole. According to ECB staff simulations, world trade in goods could fall by up to 3% already in the first year after the change in tariffs and world GDP by up to 1%. Euro area GDP would also decline, but by less than in the US.

These developments would ultimately also weigh on prices and wages. Although import prices would likely rise as a result of the increase in tariffs – with the sign and scope depending on the exchange rate reaction as well as the choices made by foreign exporters about their profit margins – consumer price inflation and wage growth are likely to decelerate as the effects of lower aggregate demand and higher unemployment can be expected to prevail, both in the United States and globally.

Perceptions of a measurable deterioration in current trade relationships could therefore potentially dent the confidence and animal spirits that are currently driving the strong economic momentum – and that policymakers worldwide have succeeded in restoring after many years of actively counteracting the effects of the crisis.
The impact could be even worse if the deterioration in trade relationships would be compounded with a weakening of the international financial regulatory agreements that were reinforced in the wake of the global financial crisis and have made the global financial system safer.[6]

These are not just theoretical considerations. While the effects of any tariffs on output and inflation may take time to materialise, falls in equity prices in response to the US announcement to impose a tariff on steel and aluminium, and prevailing uncertainty on the scope of any retaliatory measures, have already contributed to tighter financial conditions.

The S&P 500 index fell by more than 1% on the day of the US announcement of its intention to impose steel and aluminium tariffs. Equity market prices fell more markedly in countries with large current account surpluses. In Germany and Japan, for example, the major stock market indices were down by more than 4% on the day after the announcement. The US decision on 22 March of further tariffs on Chinese imports exacerbated market concerns, with the S&P 500 down by nearly 5% on the day after the announcement. Industrial sectors directly affected by the tariffs were amongst the biggest losers.

Such movements appear more pronounced than would be consistent with the direct economic effects of the measures announced to date. They seem to anticipate the effects of retaliatory measures and price in some chance that the scenario I described earlier may occur. And by fuelling

uncertainty among market participants, fears of a "trade war" have added to the volatility already witnessed earlier this year in equity markets. None of this supports growth and employment.

Longer-term influences

Besides short-term cyclical factors arising from a potential transition to a more protectionist regime, there are likely to be longer-term effects on the economy too. Trade openness supports growth in productivity and hence the long-run potential output of our economies.

Competition from trade, and the benefits offered by larger markets, can encourage a more efficient allocation of labour and capital across sectors and across firms. This improved allocation supports innovation and hence productivity. This is why the EU Single Market is at the heart of the European integration process.

These effects are also borne out by the data. According to one estimate, EU GDP per capita would be as much as a fifth lower in the absence of the integration since 1950.[7]

This is supported at the microeconomic level as well. Data collected by the Competitiveness Research Network confirms that European firms that export are more productive and pay higher wages than non-exporting firms in the same sector. Moreover, this is not simply because exporting firms are more productive in the first place, but also because firms become more productive through exporting. Firms in their first year of exporting post greater productivity gains than similar businesses that do not export.[8]

Barriers to trade would undermine this virtuous process and thereby cause both productivity and potential output to decline. The potential growth rate of advanced economies has already slowed over recent decades, reflecting a number of factors, including the ageing population,[9] as well as declining productivity growth.

So to sum up, why does protectionism matter for central banks? First, because a "trade war" scenario would add to global uncertainty at a time when some central banks have only just begun the process of unwinding the unconventional policy measures put in place following the global financial crisis. And second, because a further adverse structural shock to productivity may lead us to be more often constrained in the longer term by the effective lower bound on nominal interest rates and to increase the need to resort to unconventional policy measures.

Conclusions

Let me conclude.

Greater global economic integration has boosted living standards worldwide and lifted millions out of poverty. Yet, its distributional impacts both across and within countries have not been adequately addressed, a fact that ultimately provides the political motivation for the protectionist moves we observe.

Winding back globalisation is the wrong solution to address these concerns. A retreat from openness will only fuel more inequality as import prices rise, goods become dearer and real incomes fall. It would deprive people of the undisputed economic advantages that trade and integration bring and thereby exacerbate economic hardship for the poorest in society. And it would breed distrust among nations, making for a more unstable international order.

The distributional and social effects of greater economic integration should rather be addressed by targeted policies that achieve fairer outcomes. This requires a strong political and institutional landscape which can ensure that the geographical scope of policy action and political debates coincide with the scope of market integration. This is a landscape which in Europe is best provided by the European Union.

By allowing Member States to recover some of the state functions that have been eroded by globalisation, the European Union is a vehicle that brings the benefits of economic openness to the greatest number of its citizens while protecting them against untrammelled global forces. It represents the most progressive model we have for taking back control of globalisation by addressing people's concerns over open markets and fair competition – doubts that individual countries on their own cannot dispel.

Thank you.

[Update:] A preliminary version of the speech was published and replaced with the correct version on 6 April 2018.

[1] See University of Chicago, IGM Economic Experts Panel: **http://www.igmchicago.org/surveys/steel-and-aluminum-tariffs?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+igmforum+%28IGM+Forum%29**.

[2] See World Economic Forum: https://www.weforum.org/agenda/2017/11/what-your-country-thinks-of-globalization.

[3] See Cœuré, B. (2017), "Sustainable Globalisation: Lessons from Europe", *Revue d'économie financière*, 125, April.

[4] See e.g. Bloom, N. (2009), "The impact of uncertainty shocks", *Econometrica*, 77(3): 623-685.

[5] See WTO (2017), Global Value Chain Development Report 2017.

[6] See Cœuré, B. (2017), "The perils of isolation", speech at the Council of Foreign Relations, New York, 19 April.

[7] See Badinger, H. (2005), "Growth effects of economic integration: evidence from the EU Member States", *Review of World Economics*, 141(1): 50-78.

[8] See ECB (2017), "Firm heterogeneity and competitiveness in the European Union", Economic Bulletin, Issue 2/2017.

[9] See Nerlich, C. and J. Schroth (2018), "The economic impact of population ageing and pension reforms", Economic Bulletin, Issue 2/2018.