July 2019

ECONOMIC POLICY DIGEST

Economics of European integration, trade sanctions, capital controls and currency choice

The 68th *Economic Policy* Panel Meeting, hosted by the Oesterreichische Nationalbank in Vienna on 4-5 October 2018, featured the five papers summarised in this issue of *Economic Policy Digest*.

BENEFITS OF MARKET INTEGRATION:

New study revisits the 'cost of non-Europe', including after Brexit

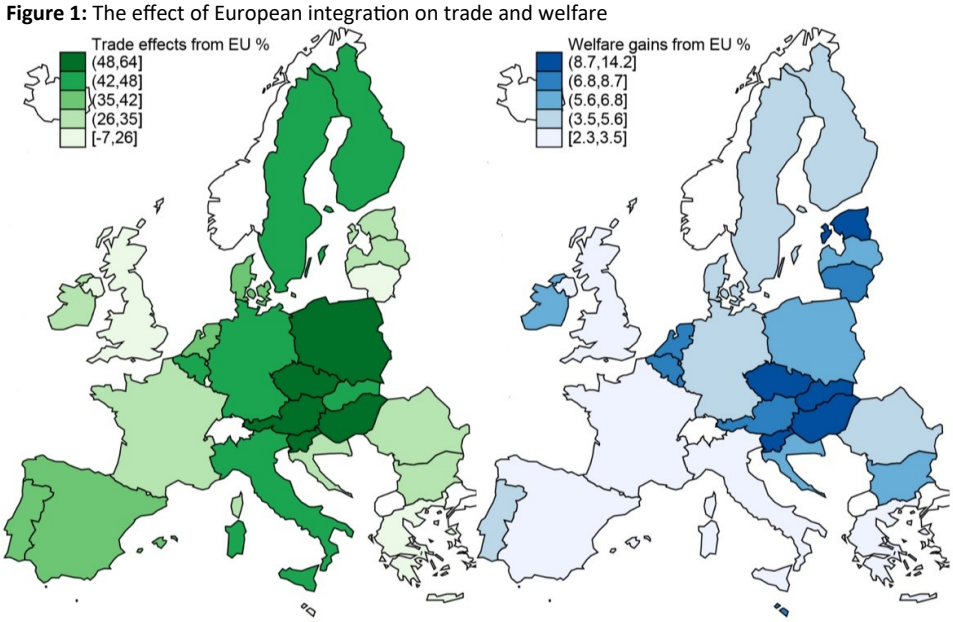
[read]

The European Union's Single Market has increased trade between members by 109% on average for goods and by 58% for tradable services. These are among the findings of research by *Thierry Mayer, Vincent Vicard* and *Soledad Zignago*.

Their study revisits the gains that EU members have reaped from trade integration since 1957 and what the impact of going backwards would be – the 'cost of non-Europe'. The results show that the beneficial effects of the EU are large and getting larger over time. What's more, the trade impact of the Single Market is more than three times larger than the effect of a 'regular' regional agreement.

But not all countries have benefited to the same extent. The gains from EU integration are significantly larger for small open economies than for large EU members (see Figure 1). It is also very striking that East European countries have been major beneficiaries of integration.

Figure 1: The effect of European integration on trade and welfare



The researchers analyse the case of a return to standard regional agreement with and without the UK having exited the Single Market. It appears clear that Brexit would reduce the gains from EU integration for the remaining members.

While on average the forgone gains would be small, they could be substantial for countries that have special linkages with the UK economy. For Ireland, which is particularly exposed to the exit of its main economic partner, the reduction in the gains from EU integration would be close to 40%. Malta and Cyprus would also experience a substantial reduction in the gains they derive from the EU after Brexit.

THE EUROPEAN REGIONAL DEVELOPMENT FUND:

New evidence from Latvia of the impact on firms' performance

[read]

Regional support funds provided by the EU boost the capital investment and employment of recipient firms. But their effect on firms' productivity is

more variable: the impact is bigger for recipients with initially low productivity. These are among the findings of research by *Konstantīns Beņkovskis, Oļegs Tkačevs* and *Naomitsu Yashiro*.

Their analysis of rich data on firms in Latvia suggests that EU funds can be made more effective by targeting firms with larger room for catching-up. At present, among all Latvian firms, those that are larger and more productive are more likely to receive the European Regional Development Fund (ERDF).

Such 'self-selection' of larger and more productive firms into the ERDF is in line with the observation that the disbursement of EU funds is associated with large administrative burden and compliance costs. Such entry barriers must be reduced to allow smaller and less productive firms, which have a great need for investment to grow, to be included in the pool of potential recipients.

Further efforts by the European Commission to streamline regulations on EU funds would be welcome, as would efforts by national authorities, such as offering technical supports on application to and implementation of EU funded projects to smaller firms.

FRIENDLY FIRE:

New evidence of the trade impact of the Russia sanctions and counter-sanctions

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Economic sanctions are often used as a tool of foreign policy, but they can also hurt domestic firms that are doing business in the target country. New research by *Matthieu Crozet* and *Julian Hinz* finds just such an effect from the sanctions associated with the diplomatic conflict between 37 countries and Russia in response to the simmering hostilities in eastern Ukraine since 2014.

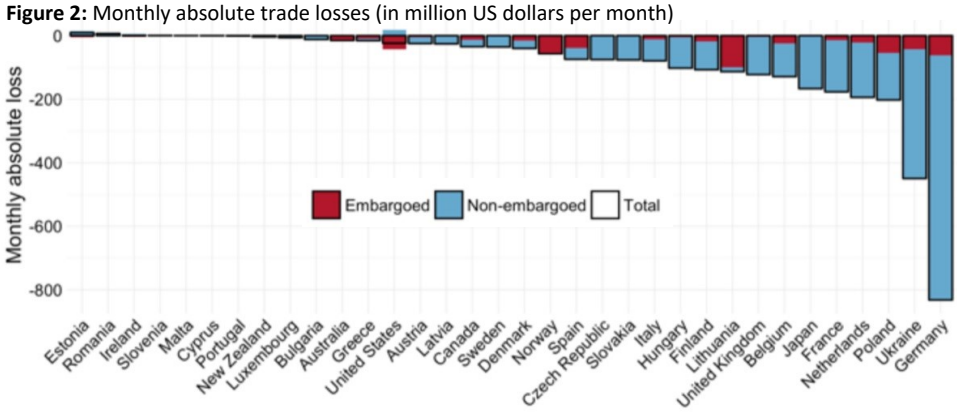
Their study finds that while the Russian Federation has borne the brunt of the costs with a loss of exports worth $53 billion, Western sanctioning countries have also been affected with a loss of $42 billion.

The composition of the losses in Western countries is very heterogeneous, with EU members bearing 92% of Western lost trade. Particularly noteworthy is that 87% of this lost trade can be considered 'friendly fire', being exports of non-embargoed products or of embargoed products before the implementation of Russian counter-sanctions (see Figure 2).

While a decrease in exports of embargoed products is no surprise, the researchers investigate why those products that were not directly targeted by any policy were also significantly affected. Analysis of French firm-level data finds a significantly stronger effect of the sanctions for those export flows that use trade finance services intensively.

This result indicates that country risk in general, and financial sanctions in particular, contributed significantly to the drop in exports of those goods that were not directly targeted by any specific trade restrictions. What's more, the French firms that were affected by the sanctions were by and large not able to recover their losses by shifting their exports to other destinations.

Figure 2: Monthly absolute trade losses (in million US dollars per month)



CAPITAL CONTROLS:

Prejudices and 'guilt by association' cloud judgment on the potential value of measures to manage financial inflows

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Capital controls have a bad name. While their usefulness as a policy tool to manage the risks associated with capital inflows is being increasingly acknowledged since the global financial crisis, they are still viewed with considerable suspicion and misgiving.

According to a new study by *Atish Ghosh, Jun Il Kim* and *Mahvash Qureshi*, a key reason for this attitude toward capital inflow controls is 'guilt by association' with controls on capital outflows that have typically been employed by autocratic regimes or those with failed macroeconomic policies.

The researchers delve into the historical record. Drawing on extensive information from primary and secondary sources, they trace both the use of capital controls and how thinking about them has evolved since the late nineteenth century 'golden era' of financial globalisation.

Examining data on capital controls dating back to the 1950s, they find that as autocratic governments became more restrictive in terms of capital account openness, democratic governments subsequently became more liberal. Conversely, no such feedback exists from the behaviour of democratic governments to autocratic governments.

The study concludes that controls on capital inflows have an undeservedly bad name. Like any other policy instrument, they have their pros and

cons. Yet they seem to be judged not so much on their merits as by prejudice rooted in history.

Correcting unfounded perceptions is important to ensure that policy-makers respond optimally to manage the risks associated with fickle capital flows, and do not shy away from using measures simply because of the connotations their name evokes.

MARS OR MERCURY?:

The geopolitics of international currency choice

[read]

How do central banks and governments choose the currencies they hold as international reserves? One answer is that they engage in a careful economic calculus, holding the currencies of large countries to which they are exposed through trade and financial flows.

But a second view is that central banks and governments favour the currencies of geopolitical partners on whom they rely for their security umbrella. Holding its currency is a way of bestowing a favour on that security guarantor. Insofar as the two countries are partners in a security alliance, the reserve holder's investments in the partner country will be relatively secure. And the leading power, for its part, is likely to possess political leverage with which to encourage the practice.

The paper of *Barry* Eichengreen and his co-authors* documents the importance of this second, security-based explanation. They use data on the currency composition of foreign exchange reserves in the period leading up to World War I when security alliances proliferated. They show that military alliances boosted the share of a currency in the partner's foreign exchange reserve portfolio by about 30 percentage points.

Applying these estimates to today, the authors find that security alliances go a long way toward explaining why the US dollar so dominates the reserve portfolios of traditional US allies such as Germany, Japan, South Korea, Saudi Arabia and Taiwan.
Barry Eichengreen and his co-authors use these estimates to gauge the impact on the dollar's role of stand-alone, inward-looking policies. In a hypothetical scenario where the US withdraws from the global stage but the level of global reserves remains unchanged, the estimates suggest a roughly 30 percentage point reduction in the share of the dollar in the reserves of US-dependent states, and an increase in the share of other reserve units such as the euro, yen and renminbi.

The estimates also imply that over $800 billion of official dollar-denominated assets – equivalent to almost 6% of US marketable public debt – would be liquidated in this hypothetical scenario, while long-term US interest rates would increase by as much as 80 basis points.

Finally, the estimates suggest that deeper European cooperation in domains such as foreign policy and external security may be relevant to the euro's global standing.

**The views expressed in this paper are those of the authors and do not necessarily reflect those of the ECB or the Eurosystem.*

The five papers featured in this digest are forthcoming.
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