Economics of Trade Wars and the Eurozone

The 70th Economic Policy Panel Meeting, hosted by the Bank of Finland in Helsinki on 10-11 October 2019, includes two papers on trade wars and two on issues in the Eurozone. All four are summarised in this issue of Economic Policy Digest.

US–CHINA TRADE WAR:
New evidence that protectionist tariffs hurt those they are meant to protect [read]

Protective tariff measures introduced by the United States against products from China, as well as retaliatory actions by China against US products, have achieved more or less the exact opposite of what they were at least officially intended to do, harming firms in the very industries they were supposed to protect. That is the central finding of new research by Peter Egger and Jiaqing Zhu.

Their study analyses the early consequences of the trade war between the United States and China by focusing on the stock market reactions of all listed firms in the United States, China and 38 other countries and territories within windows of up to 10 days after multiple tariff announcement events between March 2018 and May 2019.

A key insight from their analysis, which is consistent with anecdotal evidence coming from business, is that the protectionist tariffs hurt the domestic firms of the country that implements them – and even more so in the United States than in China. What’s more, with modern business organised in global value chains, the tariffs are causing extensive collateral damage to untargeted sectors as well as to third countries.

TRUMP’S TRADE WARS:
Why they may make sense now – but what longer-term damage they may do to the rules-based multilateral trading system [read]

A new study of recent US trade actions by Aaditya Mattoo and Robert Staiger presents an interpretation that is at once more charitable and less forgiving than that typically offered by economic commentators.

Their analysis is more charitable, because it suggests a possible logic to these actions: the United States is initiating a move from ‘rules-based’ to ‘power-based’ tariff bargaining. It is selecting countries with which it runs large bilateral trade deficits because it has the most leverage over them.

The authors’ interpretation is less forgiving, because it implies that the costs of these trade tactics cannot be avoided even if they happen to deliver greater openness abroad. Rather, the main costs will arise from the use of the tactics themselves, and from the damage done to the rules-based multilateral trading system.

A less myopic approach would dictate greater US restraint, the researchers conclude. If other countries follow the US example, then the United States will be likely to lose any benefits from its actions, and multilateral trade cooperation will collapse. If US actions durably damage the rules-based system, the United States may ultimately be hurt by the absence of restraints on the actions of a future hegemon.

This has a surprising implication: if the transition from US to Chinese dominance of the world economy cannot be avoided, and if a ‘hegemon’ is needed to maintain the rules-based trading system, then the United States might be better off facilitating China’s rise and potential hegemony (see Figure 1). This could be in the country’s enlightened self-interest.
The euro is punching below its weight as an international currency: New research explains why. Twenty years after the euro was launched, its role as an international currency is no greater than the German Deutsche mark and the French franc, which it replaced (see Figure 2).

New research by Ethan Ilzetzki, Carmen Reinhart and Kenneth Rogoff demonstrates the currency’s distant second status behind the dollar, notes the emerging threat of China’s renminbi as a competitor in the world monetary system, and explains why the euro punches so far below its weight. The authors’ central explanation for the euro’s lagging role is the shortage of safe euro-denominated assets, which is partly due to the highly fragmented financial markets in the Eurozone. For example, an asset issued in Italy or Greece isn’t viewed as a close substitute for German bonds. Indeed, the Eurozone functions more like economic archipelago than a unified financial and economic zone.

The Eurozone’s limited unity, particularly in the post-crisis decade, has also posed difficulties for monetary policy. The study finds evidence that the European Central Bank (ECB) was slow to find its own voice and its 20 years can be divided into a ‘Bundesbank-plus’ period and a ‘whatever it takes’ period.

The first decade showed a slow transition from the European Exchange Rate Mechanism with stable German inflation as its goal. In this period, the ECB’s implicit policy rule put a far greater weight on German inflation than on inflation in the Eurozone as a whole.

The second period has been characterised by zero and negative interest rates, and an expanding ECB arsenal of credit facilities to European banks and sovereigns. Lack of ECB policy clarity makes the nature of the euro hard to assess and therefore a less attractive currency to use as an anchor. This may be an additional factor limiting the euro’s international reach.

The fiscal-monetary policy mix in the euro area: Former ECB official on what’s needed now.

The euro area has suffered a much deeper and protracted slump following the global financial crisis than Japan and the United States, and it remains fragile (see Figure 3). Fiscal policy and monetary policy have been inappropriately tight and this is contributing to greater divergence across member states. To some extent, the failure can be attributed to institutional weaknesses, gaps and ambiguities in the construction of the euro.
These are among the conclusions of a new study by Athanasios Orphanides, former Governor of the Central Bank of Cyprus and member of the Governing Council of the European Central Bank (ECB). He notes that fiscal policy has been hampered by the institutional framework, which constrains individual states, and lacks instruments to secure an appropriate aggregate stance.

At the same time, ECB monetary policy has been hampered by the distributional effects of balance sheet policies that needed to be adopted at the zero lower bound, and by discretionary decisions taken before the crisis, such as the reliance on credit rating agencies for determining collateral eligibility for monetary operations. The compromising of the ‘safe asset’ status of euro area sovereign debt during the crisis complicated fiscal and monetary policy.

European institutions cannot solve the euro area’s deep political problems, Professor Orphanides observes: ultimately, the viability of the European project is in the hands of the elected governments of Europe. Nevertheless, he concludes, the ECB can use its discretionary authority to provide appropriate monetary accommodation and reduce distributional effects of prior discretionary decisions, which have hampered the effectiveness of its monetary policy. Such actions would improve the fiscal-policy mix in the euro area and contribute positively to the longer-term prospects for the euro area.

The four papers featured in this digest are forthcoming.

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