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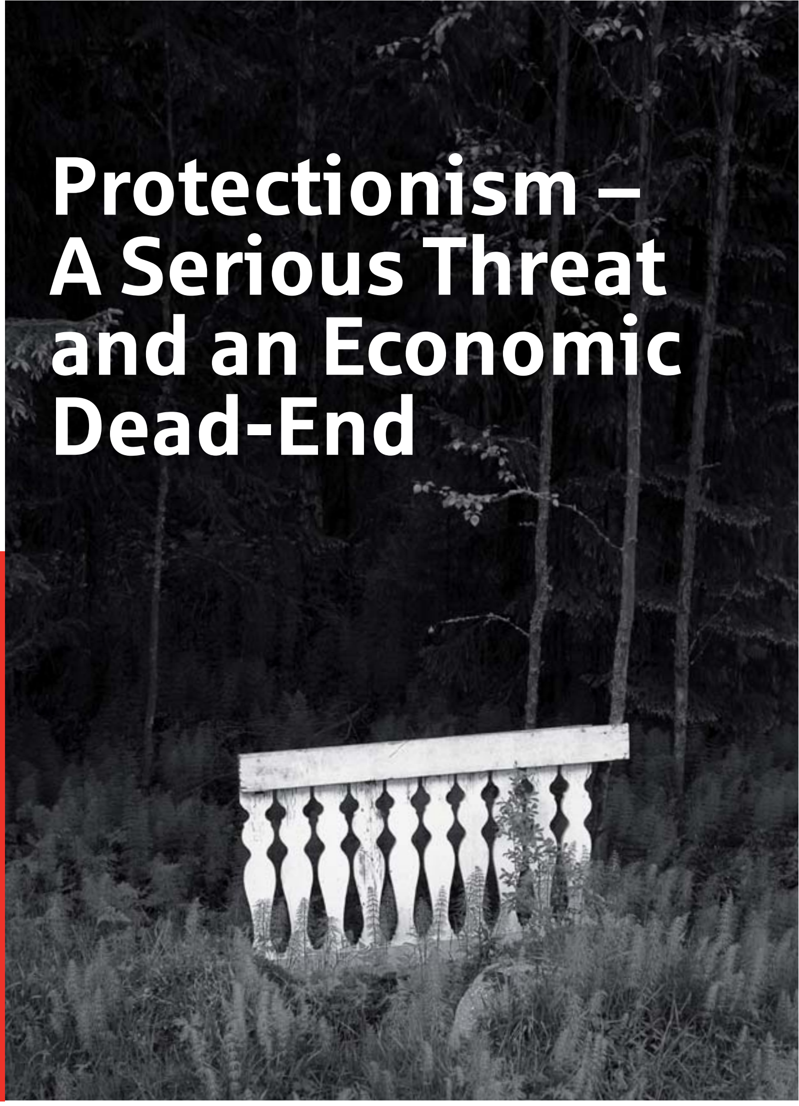
Protectionism – A Serious Threat and an Economic Dead-End



- Protectionism is a populist response to economic problems which are profoundly complex and cannot be reduced to trade conflicts.
- Protectionism threatens to escalate into global trade wars, with dramatic consequences for the world economy.
- Structural reforms are necessary to reduce external economic imbalances and combat the motives for protectionism.
- A 45 percent tariff on all imported products (although this high rate announced by Trump is unlikely to become reality) would cost the USA nearly USD 300 billion in extra inflation (+1.6 percentage points) and nearly USD 170 billion in GDP growth (-0.9%).
- The resulting burden for Germany/Euro area would amount to EUR 22 billion and EUR 64 billion, respectively (GDP growth effect: -0.7/-0.6% percentage points).

Berlin, 12 May 2017

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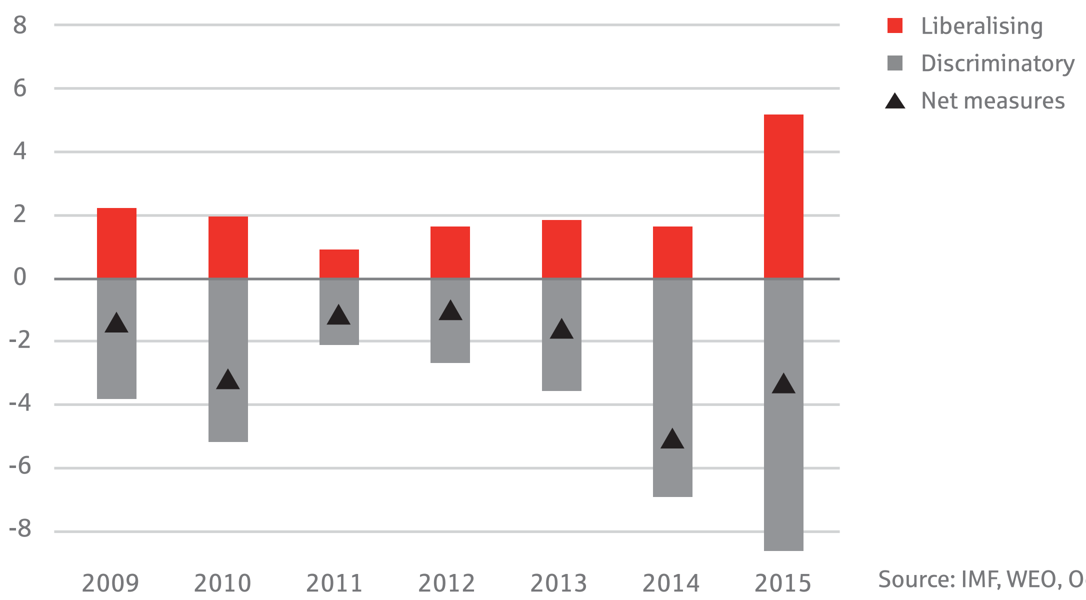
Protectionism – A Serious Threat and an Economic Dead-End

„Protectionism and populism are the principal risks for 2017“ was the conclusion drawn by relevant economic risk analyses at the beginning of the year. This topic has thus upstaged other risks such as international terrorism, military or political confrontations, migration movements and climate change.

Historically, trade growth and economic prosperity have always gone hand in hand. Restrictions on trade will stunt aggregate economic growth. Nevertheless, weaker market participants repeatedly demand protective measures as, in their eyes, free trade only benefits the market leaders and results in external economic imbalances. Trade is in the mutual interest of all parties involved. However, the welfare gains from trade are based on the benefits of specialisation, and this inevitably presupposes economic change – the implication being that some market participants in some countries will ultimately end up on the losing side. Yet the world is not digital. No country has unregulated cross-border trade.

Trade agreements are highly differentiated and complex, and trade disputes are bound to occur. In practice, conflict about free trade and protectionism is less of a dispute about axiomatic principles – and more a question of getting the balance right. At the moment, however, the pendulum is swinging very much in the direction of protectionism.

Trend in trade barriers for export products



Source: IMF, WEO, Oct. 2016, p. 80

Since 2008, the World Trade Organisation (WTO) has registered an increase in sectoral and product-related protectionist measures in a large variety of countries (chart 1). The election of Donald Trump to the office of US President, in particular, was a rallying cry for those demanding greater protection for their particular domestic economy. Furthermore, for some time now we have seen a rise in the prominence of parties or movements in many countries in the Western world which propagate sealing off their nations from the world market as a means to achieve greater security and stability.

Protectionism – a meander

The Costs of Protectionism

Donald Trump announced, in the context of the „America First" politics he outlined after his election, that he was intending to introduce tariffs on imports of up to 45 percent and to recalibrate external economic relations on a bilateral basis in order to shield US companies from „unfair trade agreements" or „manipulated currencies". This has created deep uncertainty in the global economy.

Import bans or high tariffs are detrimental as they reduce the size of the relevant market (poorer economies of scale, cf. also 4.) and make it more expensive, or indeed impossible, to employ the best available technological solutions (disadvantages of specialisation). This necessitates adjustments in capital allocation.

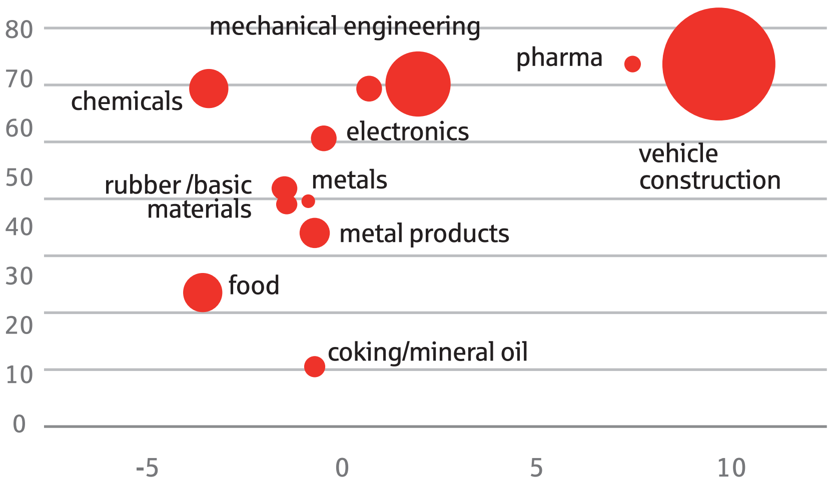
The shock caused by knee-jerk implementation (e.g. of measures against Mexico) will lead to significant write-offs and losses for the affected companies, imparing their innovative capacity. Import substitution through expansion investment or foreign investment will admittedly generate positive growth effects in protectionist countries but, on the whole, unit costs will probably rise. In other words, adjusting the production structure will entail write-offs (capacity reduction) on the one hand and investment (capacity enlargement) on the other, without expanding production as a whole. This will cause a decline in both productivity and growth.

Abrupt changes in foreign trade relations would be of particular concern (admission of imports or exports, shifts in import tariffs). A country's economic structure (investment, production, contractual agreements) is crucially influenced by the prevailing price relationships. Radical alterations therefore threaten the status quo. The impact of adjustments is usually mitigated by transition periods and by the step-by-step phasing-in of new measures.

Rising prices for now more expensive imports or domestic production siphon off income from both investors (capital goods) and consumers (consumer goods), as well as imposing a burden on the sale of further goods and services and, thus, on aggregate growth. If a price-wage spiral then emerges as a second round effect, inflation will climb further, requiring restrictive countermeasures from the monetary authorities. Both of these effects will affect aggregate growth, with a subsequent threat of stagflation. Abroad, by contrast, write-offs will lead to lower production, putting pressure on employment, income, growth and inflation. Both sides will lose out.

In a scenario calculation of the (presumably relatively theoretical) worse case for Trump's trade policy, a 45 percent tariff on all imported goods would result in growth losses of -0.9% and an inflation effect of +1.6 percentage points for the USA. The fact that imported products were now 28 percent more expensive would cause imports into the USA to plunge by 16 percent. This would have by far the most adverse effect on Mexico and Canada. All the same, GDP growth in the eurozone, and in Germany too, would be substantially impaired (by -0.6 percent and -0.7 percent, respectively). In Germany's case, the automobile and pharma sectors have a particularly large exposure to US export business

Degree to which manufacturing sectors are vulnerable to Trump's protectionism x-axis: deviation of US export share from average in %-points vs. y-axis: share of foreign turnover in %



Bubble size reflects the ratio of sectoral turnover to aggregate turnover in manufacturing industry
export data for 2016;
turnover data for 2015;

Source: Bloomberg, Destatis, NORD/LB Research

It should also be noted that the degree of competitive intensity could increase considerably in markets without protectionist measures. For instance, if China were to attempt to forcibly unload products which it can no longer sell in the USA onto the European market, the result could be significant adjustment costs in Europe.

The negative inflation and growth effects would be aggravated significantly if unilaterally affected countries were to adopt counter-measures (trade war). This would also have a negative impact on US exports. Slumping growth, in turn, reduces demand for imports and exports, and vice versa – a drastic case in point was observed during the 1930s.

Protectionism – Why?

Causes of protectionism

We see protectionist tendencies as a populist response to economic problems. The problems in question, however, are far more complex and cannot simply be reduced to trade conflicts. The following keywords should be mentioned in this context:

Technological developments (e.g. digitalisation, resulting in disruptive changes to business models, job security and in the speed with which qualifications are devalued);

Demographics (ageing populations in developed economies are limiting growth and innovation momentum whilst putting social security systems under pressure to adapt);

Migration (whilst diminishing the demographic dilemma, the voluntary and involuntary immigration of people with all levels of qualification also gives rise to social, qualification-related, cultural and religious adjustment problems, e.g. tougher competition on the labour market or for social resources such as affordable housing);

The financial market crisis and distribution issues (the sometimes devastating impact of the crisis on social policy and labour market policy in various countries; the distribution of crisis-related burdens; and, in contrast to that, the level of – and trend in – management salaries and bonuses);

Sluggish growth and low interest rates (high unemployment in some countries; relatively anaemic global economic growth (GDP, plant and equipment investment, world trade, productivity); a lack of strategies – or disagreement over strategies – for generating new growth; low interest rates are jeopardising the return on assets in middle-class households);

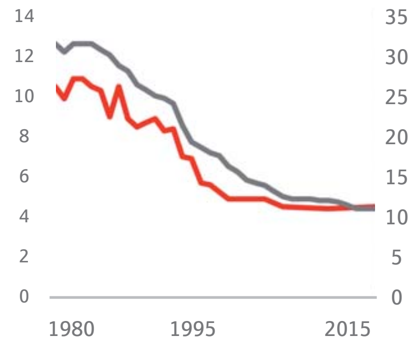
Radical changes in basic social values (family, religion, gender roles);

New forms of communication (social media, online networks).

What a number of the above-mentioned problem areas have in common with free trade is that they require people to be very open to change. Not everyone is able to show this willingness, and these individuals have an understandable and legitimate interest in a more social process of change. This impulse is causing protectionist tendencies to gain increasing support.

It is maybe no coincidence that it was in the USA and the United Kingdom that majorities in favour of a more isolationist approach could be mobilised last year. After all, both of these countries had previously been advocates and protagonists of a particularly liberal market view, which was less sympathetic to the predicament of those losing out to change.

Trend in average tariffs,
in % simple average



Developed countries (left-hand scale)
Emerging markets (right-hand scale)

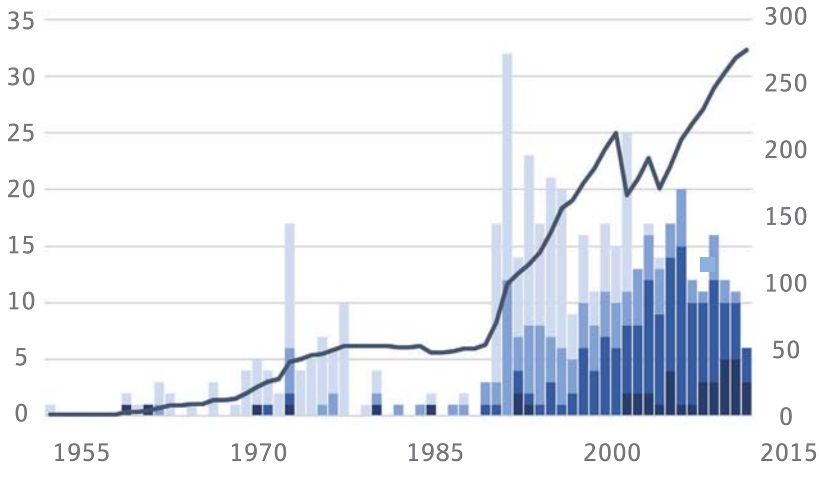
Source: IMF, WEO Oct. 2016, p. 80

The Benefits of Free Trade

What had previously been a decidedly rigid trade and currency system was progressively liberalised from 1945 onwards. This holds true for the various stages in the development of the EU (European Coal and Steel Community, Treaties of Rome, EEC, EC) and also applies internationally (first GATT, then the WTO). Over and above bilateral trade agreements, a whole network of multilateral free-trade areas has been set up (NAFTA, Mercosur, ASEAN, …).

The number of agreements, as well as the number of WTO members, has increased continually, especially since the establishment of the World Trade Organisation (WTO) in 1995, and in connection with the realignment of the countries formerly grouped in Comecon and with the opening-up of China (chart 3). It has proved possible to sustainably reduce the level of tariffs and of other trade barriers (chart 4). The effect of this can be gauged from the dynamic development of international trade.

Number of preferential trade agreements (PTAs) vs. number of countries involved



cumulativ number of PTA
more than 20
10 to 20
less than 10
came not into force

Sources: World Bank; Trade and Competitiveness Global Practice Group; Claudia Hofmann, Alberto Osnago, Michele Ruta; Horizontal Depth, A New Database on the Content of Preferential Trade Agreements; Policy Research Working Paper 7981, Februar 2017, S. 15

Subscribing to the free market credo, more and more countries aimed at integrating, or partially integrating, their economies into international trade. Both intra-EU and transatlantic trade shaped up well, contributing to macroeconomic growth in all participating countries. Trans-pacific, intra-American, Asian-European and intra-European East-West trade made headway in the 1990s.

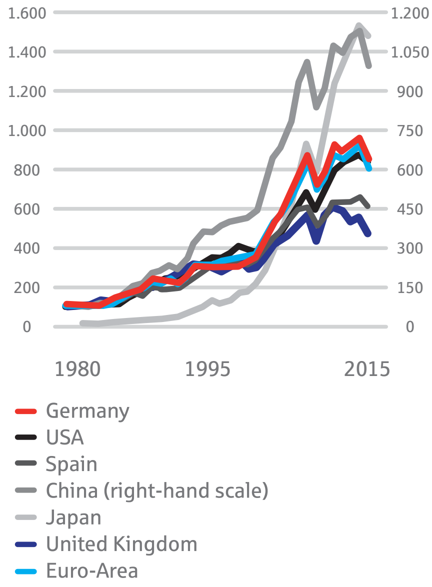
Outside of the enlarged EU, the USA and Japan, a number of threshold countries (e.g. Mexico, Brazil, China, Turkey, India) also managed to position themselves well, reaping the benefits of trade. In principle, the advantages conferred by international trade derive from two important basic economic principles – the division of labour (bringing with it the advantages of specialisation) and economies of scale (resulting from the increased size of the sales market). On the other hand, the IMF has demonstrated that trade growth is crimped by protectionism. Using the example of pin production, Adam Smith (1776) already indicated the significant productivity effects engendered by the division of labour. Later, David Ricardo (1821) famously drew attention to the comparative advantages conferred by the international division of labour.

According to this view, it benefits both trading partners (in Ricardo's example Britain and Portugal) if they focus on the products they are most efficient at making (in this case, cloth and port) and purchase goods where they do not have a comparative advantage by trading with their partners. The larger size of potential sales markets brought about by free-trade agreements increases the number of market participants and thus spurs competition, which should have positive repercussions for the price trend as well as for innovation momentum.

Pressure on prices due to competition and a larger sales market promote productivity gains through economies of scale (i.e. thanks to higher production levels, the fixed costs for development, marketing and production can be distributed more efficiently, leading to declining unit costs). Where cost reductions lead to greater demand for individual products – but also to higher demand in general and therefore higher aggregate growth – economies of scale are frequently associated with concentration processes. As the size of the market increases, so too does the company size which appears acceptable from a competition-policy point of view. Such concentration can also be disadvantageous from a competition perspective.

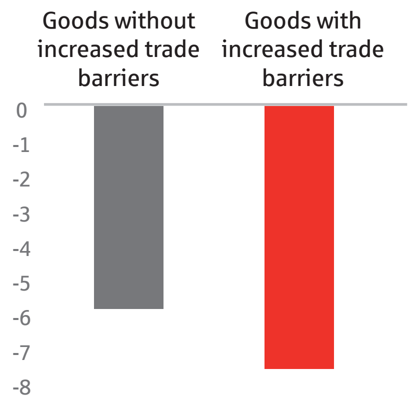
Nowadays, the largest players in the global automobile industry (VW, Toyota, GM) each record annual sales of around 10 million units. In turn, turnover and earnings of such a magnitude enable a new dimension of R&D activity (while, at the same time, leading to internal control problems of their own). This also involves spatial specialisation and value-added concentration. Such spatial concentration is system-typical and provides a justification for disparities in spatial development.

Exportdynamics, 1982 = 100, Data in US-Dollar, in % simple average



Source: WTO, NORD/LB Research

Slower growth as a result of protectionism: Slowdown in real goods import growth in % points 2012-2015 vs. 2003-2007



Source: IMF, WEO, Okt. 2016, p. 80

Problems Connected with Free Trade

It would be irresponsible to dismiss as mere lobbyism the many points of resistance and bones of contention encountered when shaping foreign trade relations.

The above-mentioned spatial disparities are just one of the factors that show the problems inherent in the win-win hypothesis underlying the free-trade dogma. Can every single economy tap comparative advantages of its own within a reasonable period of time, or will superior competitors from other countries crowd that economy's own companies out of the market? If trade deficits arise, these can only, at most, be funded temporarily; in the longer term, it would take massive currency devaluation to restore equilibrium.

However, many countries with internationally unimportant or insecure currencies are compelled to fund trade deficits in a foreign currency. This subjects them to considerable exchange-rate risks.

Trade – level-playing field important

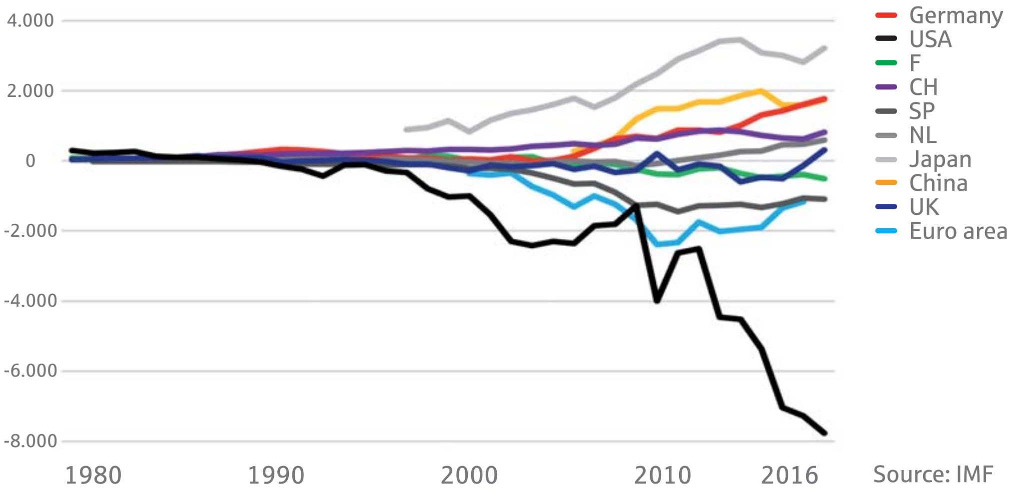
In trade, price is the primary factor when it comes to comparing products, whereas the production conditions giving rise to the products in question are often disregarded. Factors ranging from patent theft, child labour and environment degradation to illegal procurement (robbery, expropriation, ...) are examples of unacceptable competitive conditions.

Moreover, it cannot be viewed as acceptable for companies or states to pursue a strategic market policy which involves dumping prices in order to displace competitors. Many countries also reserve the right not to exclusively source products relevant to national security or national supply security from foreign countries (e.g. food, security-relevant technologies, energy and other commodities).

The equality hypothesis, according to which trading partners engage with each other in the marketplace in the classical model in order to determine the equilibrium price through negotiations, may be violated if, for example, there are power or information asymmetries or if strategic interests dominate.

Structural or, at least, persistent trade imbalances can even be seen among economically similar countries (e.g. EU, OECD). The USA and the United Kingdom have had heavy current account deficits for some time, the cumulative effect of which is rising net external debt (chart 7). Both the USA and the United Kingdom remained saddled with these deficits, even after the onset of the financial crisis.

Trend in external assets, in billion USD



Source: IMF

Despite the knowledge that it is imperative to reduce external deficits, not least by endeavouring to push ahead with structural change, it is clearly not so easy to regain lost competences.

Conclusion – What can be done?

It remains difficult to tell whether limiting free trade serves the interests of structurally conservative lobbyists or is in the legitimate interest of warding off dumping, preserving strategic competences and attaining political goals (e.g. the prohibition of child labour, circumvention of climate-policy targets, protecting professional craftsmen, book price fixing). It will take case-by-case decisions for progress to be made.

Pretectionism – a serious threat

Nevertheless, the recent surge in protectionism constitutes a genuine threat to the future trend in world economic activity. This holds true for all economies participating in the global economic process. The threat of escalation to an all-out trade war should not be underestimated.

At the same time, action is required regarding the structural trade imbalances and the need to fund them, as these too are factors which foster protectionist tendencies. Instead of putting their faith in a retrograde policy of isolationism and tariff barriers – which lead to a dead-end – deficit countries should enhance their competitiveness and ability to produce an attractive array of products.

Solutions:
to increase demand ...

By contrast, it is up to surplus countries to boost their import demand. This can be achieved by means of tax options (value-added-tax cuts, relief for those on low incomes), higher investment expenditure (e.g. on infrastructure) and approaches to increase market opening in areas in which surplus countries currently suffer comparative disadvantages (e.g. services).
In any case, the cautionary tale of the 1930s warns us that cooperation and not confrontation should be the watchword. Only if we are united will we move onto a positive path leading to higher growth.

... cooperation, no confrontation

Disclaimer

The present position paper of the Chief Economists does not necessarily correspond to the attitude of the DekaBank or the attitude of the respective Landesbanken and Savings Banks.

Publication details

Published by
Deutscher Sparkassen- und Giroverband e. V.
Abteilung Volkswirtschaft und Finanzmärkte
Charlottenstraße 47
10117 Berlin

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Layout
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Page 1: plainpicture/Mira/Mikael Andersson

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Remark
You can access this document at
http://www.dsgv.de/de/fakten-und-positionen/Standpunkte_Chefvolkswirte.html

ISSN
2509-3851