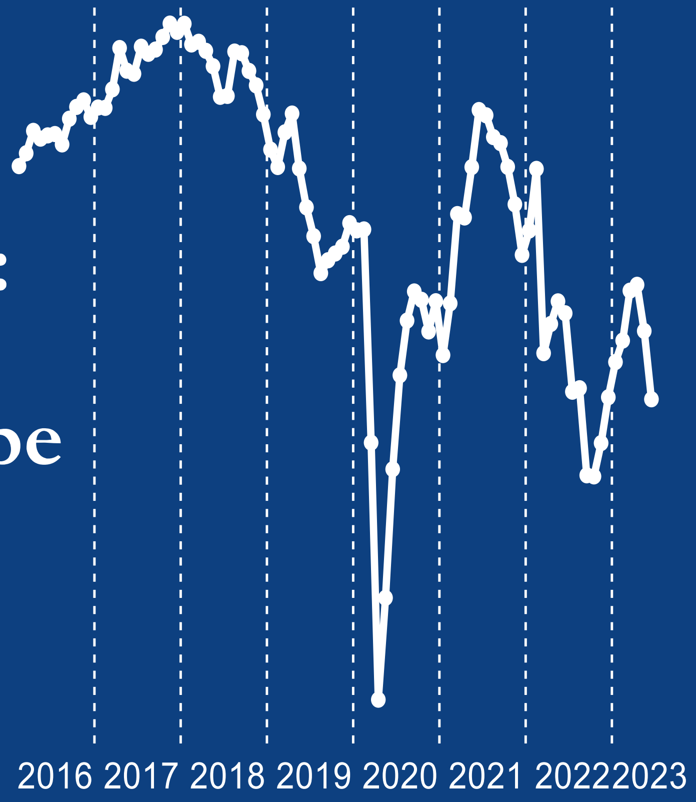
ECB WATCHERS CONFERENCE, MARCH 20TH, 2024

Debate 3: Geopolitics and Structural Change: Implications for Real Activity, Inflation and Monetary Policy – New Challenges for Europe

Clemens Fuest

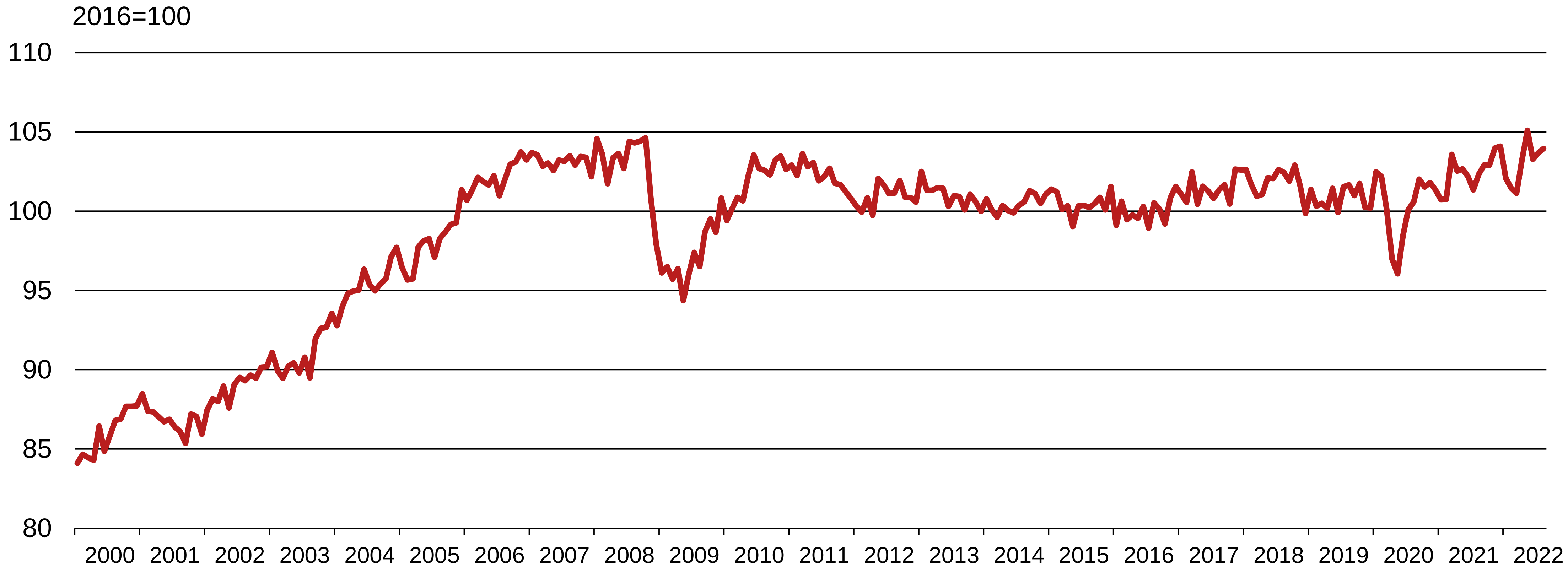


Geoeconomic challenges coincide with other negative supply shocks

- **Trade frictions** reduce European productivity and real incomes
- **Decarbonization**: Higher investment to replace stranded assets requires decline in consumption **during the transition** (OECD (2023), Pisani-Ferry (2023))
- Reduced **energy supply** (gas, nuclear in Germany)
- **Demographic change** reduces supply of labor
- Need for **higher defense spending** requires decline in consumption

„Slowbalization" in Trade of Goods – will geopolitical tensions reverse globalisation? If so, how costly is it?

Index of Globalisation of the goods market worldwide*)



*) Volume index of world trade divided by volume index of global industrial production

Source: CPB 2022.

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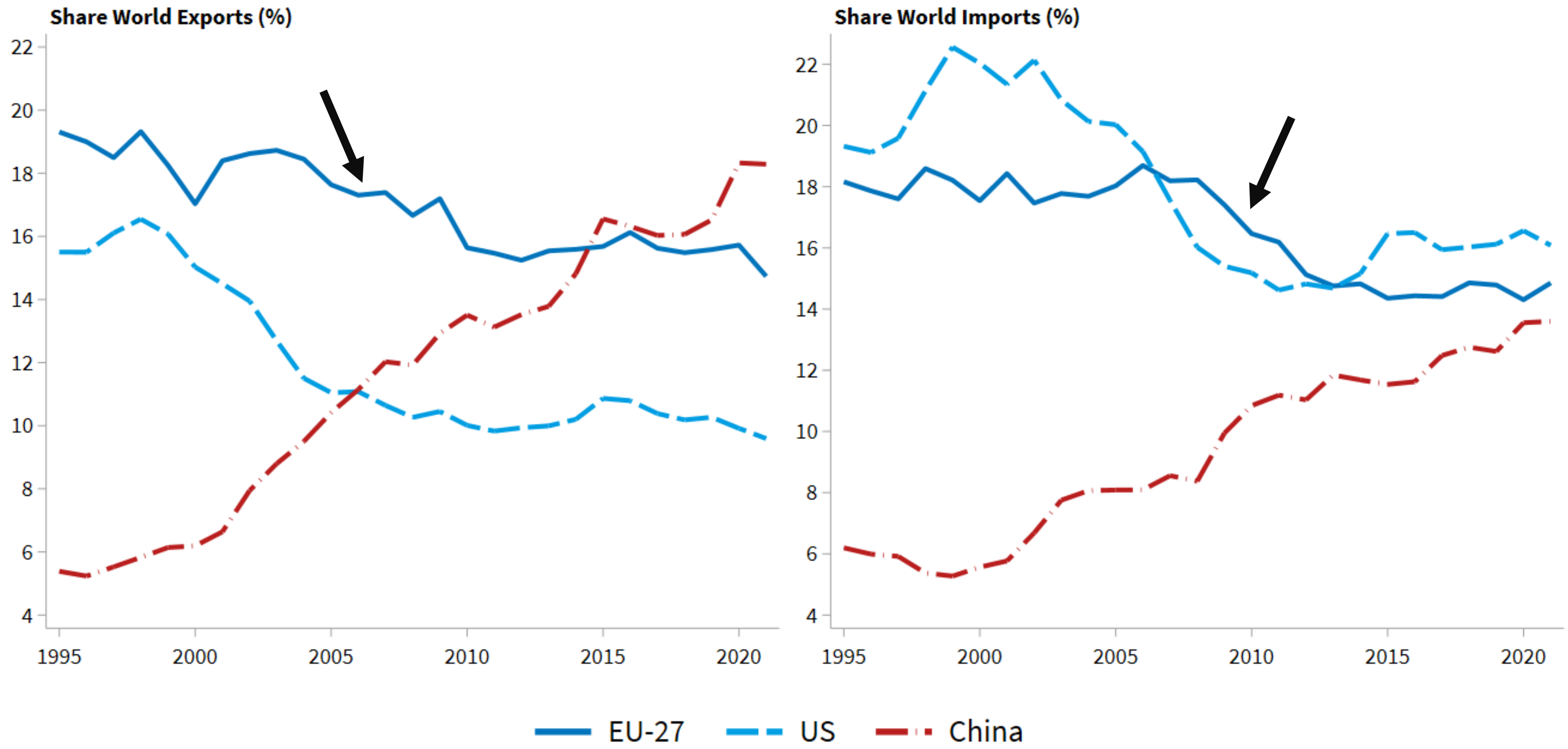
Rethinking Geoeconomics: Trade Policy Scenarios for Europe's Economy

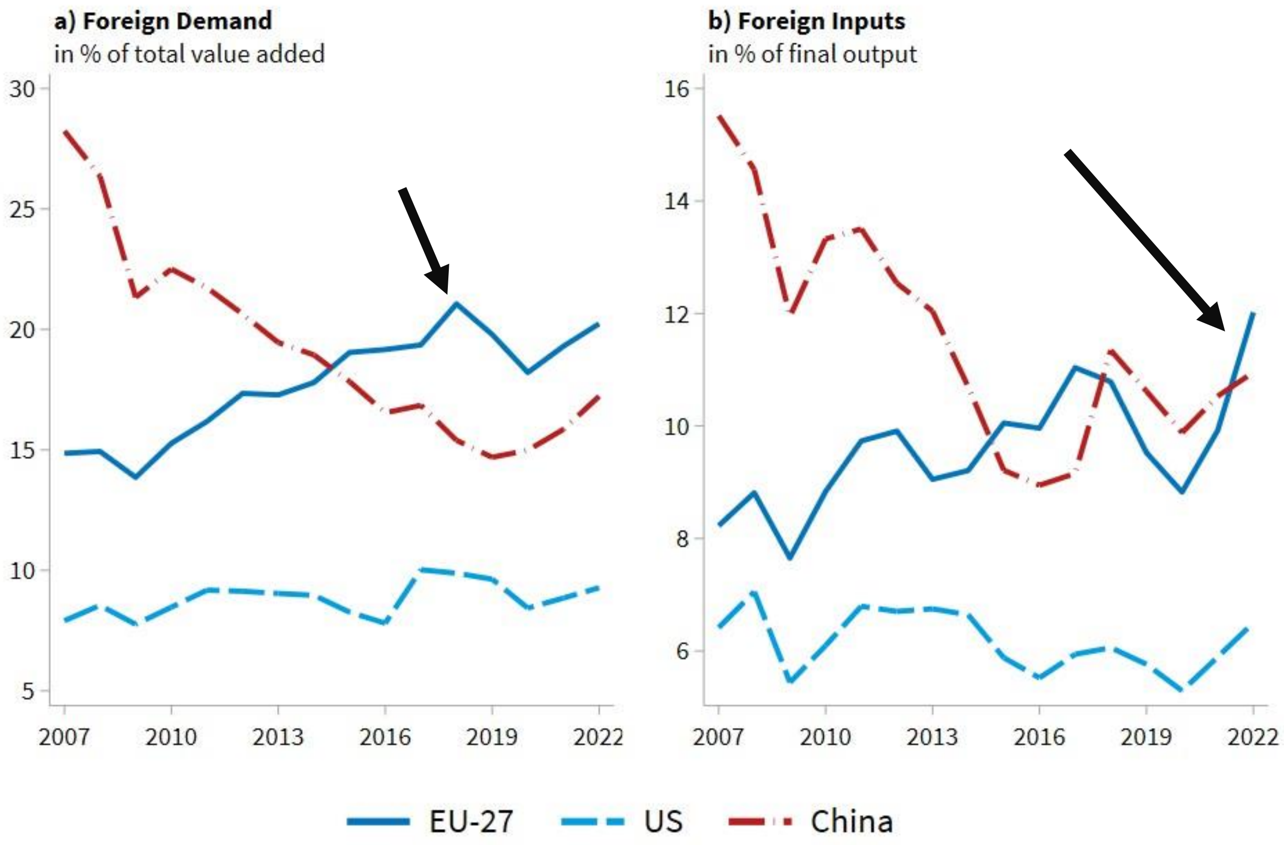
Andreas Baur, Florian Dorn, Lisandra Flach, and Clemens Fuest

The EU‘s overall role in world trade has declined…



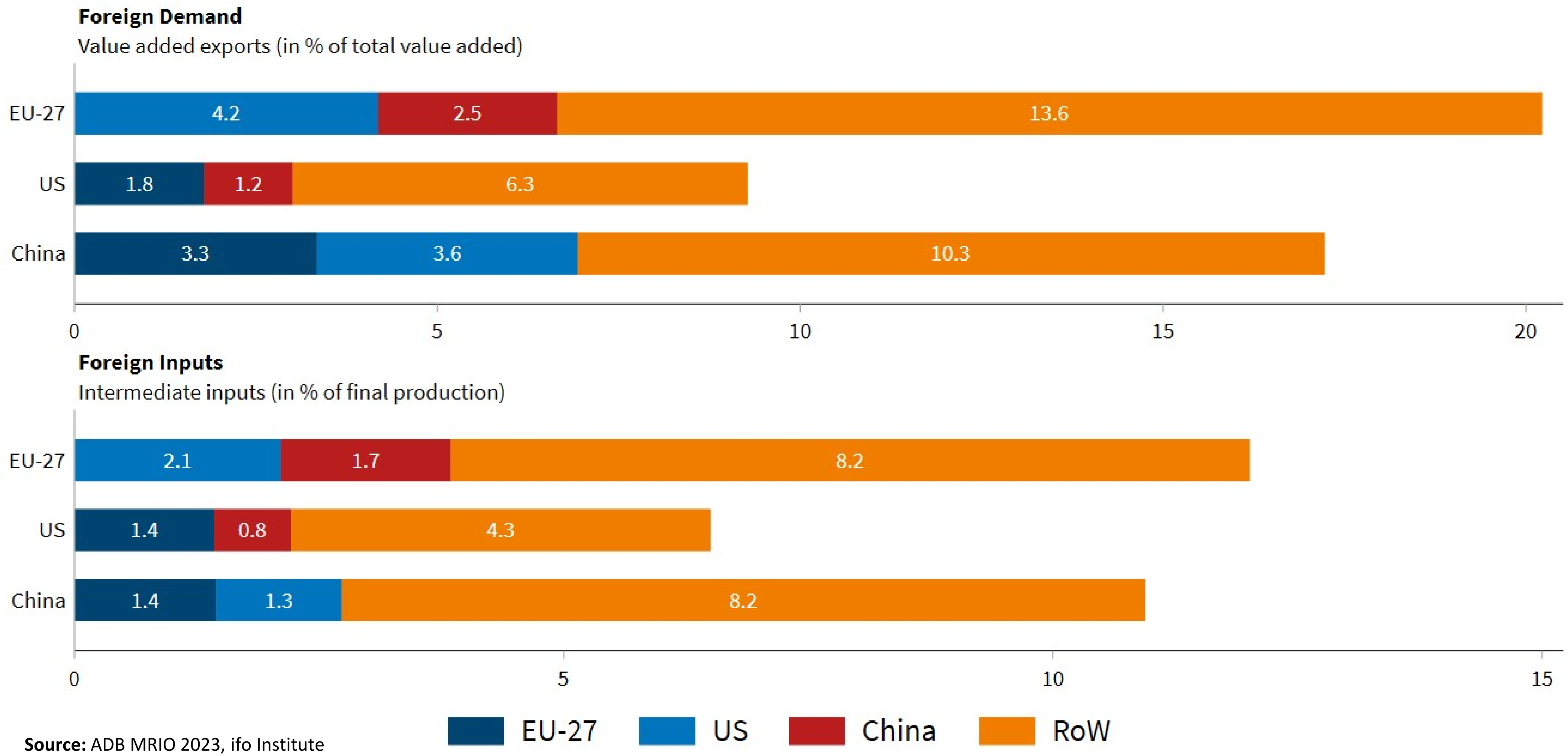
Source: BACI, ifo Institute
Note: Intra-EU trade excluded.

… but the EU‘s dependence on external trade has increased



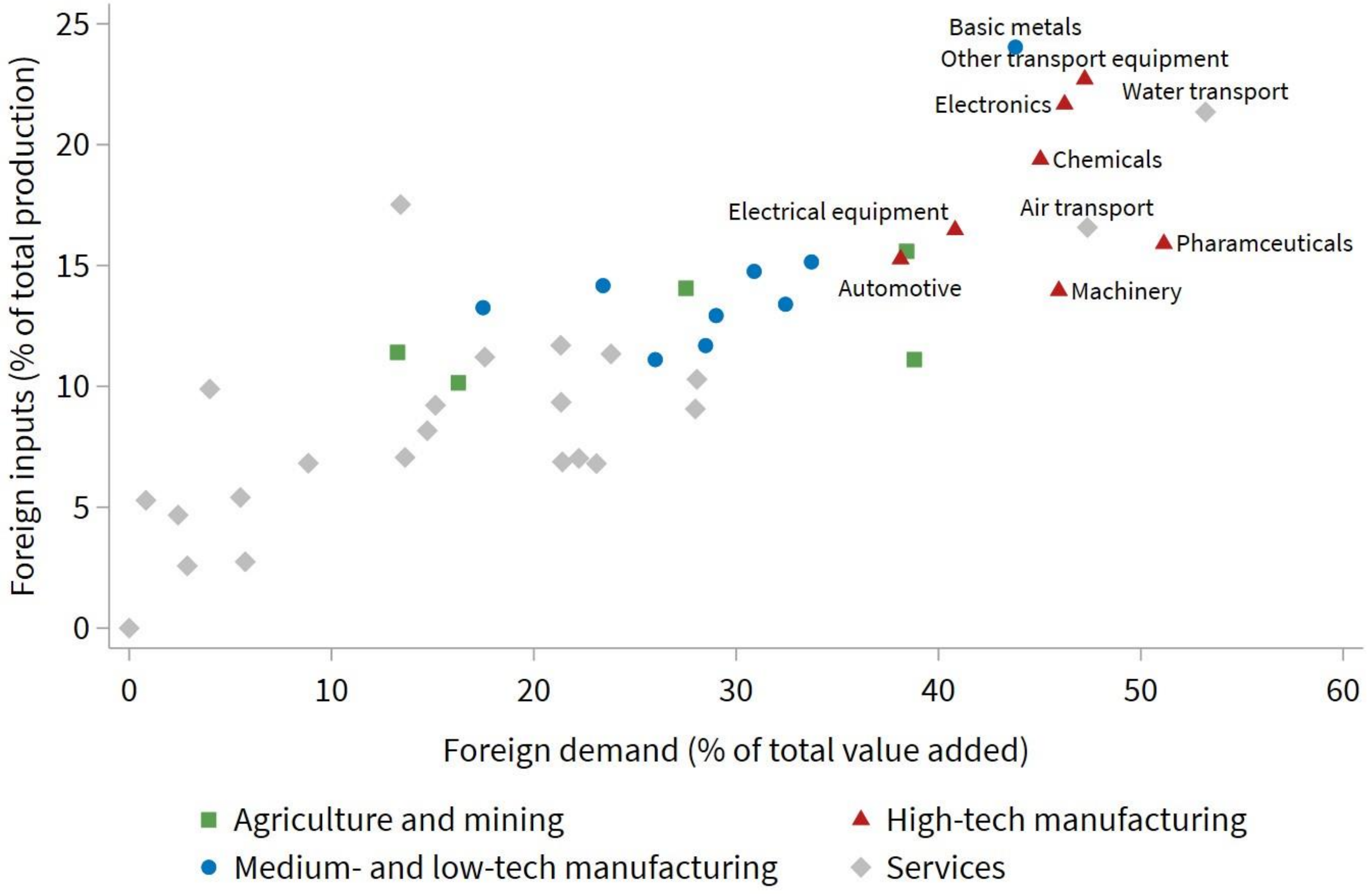
Source: ADB MRIO 2023, ifo Institute
Note: Intra-EU trade excluded.

The EU, the US and China share important but asymmetric trade interdependencies



Source: ADB MRIO 2023, ifo Institute
Note: Intra-EU trade excluded.

EU high-tech manufacturing deeply integrated into the world economy



– **Vertical Axis:** Dependence on foreign inputs

– **Horizontal Axis:** Dependence on foreign demand

Source: OECD ICIO 2021, ifo Institute
Note: Intra-EU trade excluded.

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Simulation of Geoeconomic Policy Scenarios

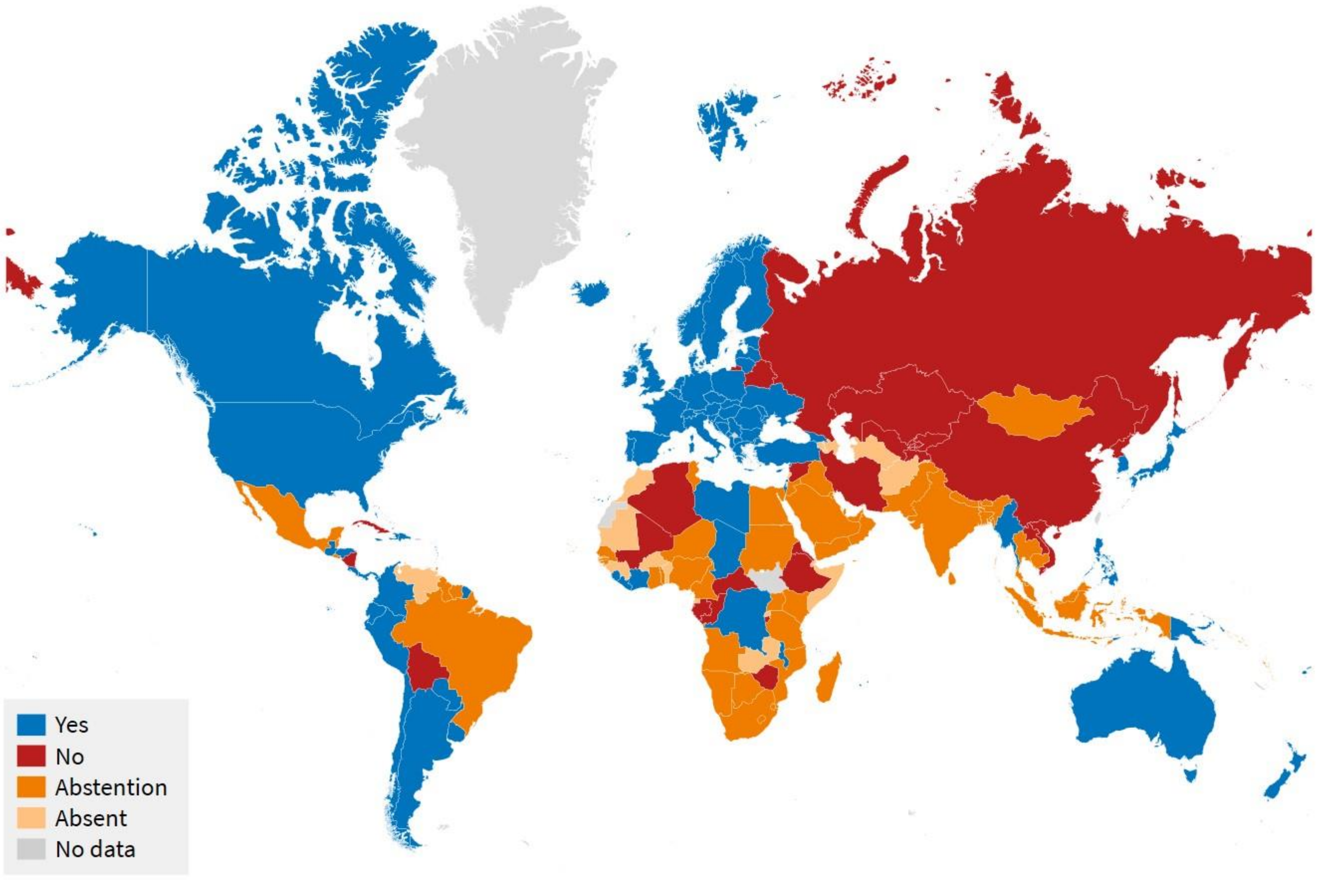
Geoeconomic Scenarios

RESHORING

- **Scenario 1:** EU imposes highly restrictive trade barriers against imports from outside the EU
- **Scenario 2:** US and China follow the EU's example and also impose trade barriers of similar size

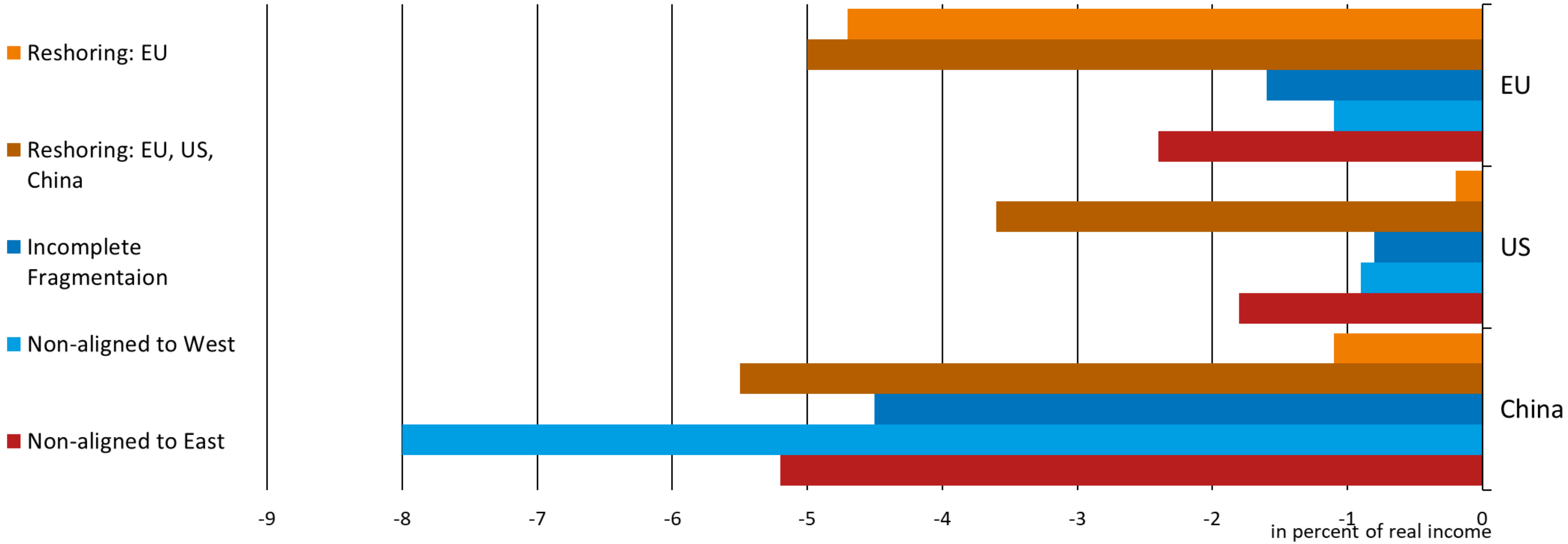
GEOECONOMIC FRAGMENTATION

- **Scenario 3:** Two geoeconomic blocs (West + East) and group of non-aligned countries
- **Scenario 4:** Complete fragmentation
  ➔ Non-aligned countries part of Western bloc
- **Scenario 5:** Complete fragmentation
  ➔ Non-aligned countries part of Eastern bloc



Geoeconomic Blocs based on UN Vote on Suspension of Russia from Human Rights Council (7 April 2022)

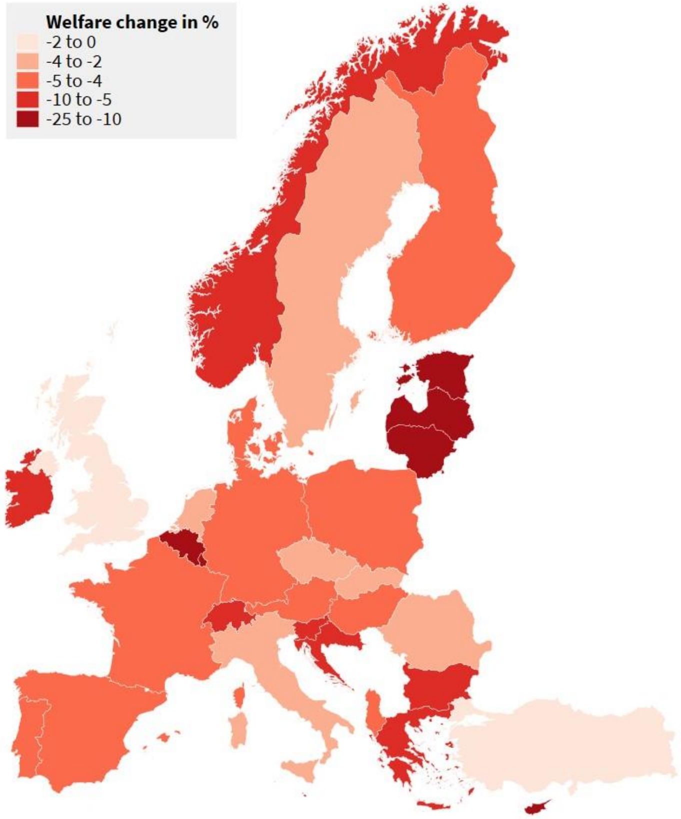
Effects on real income for different geoeconomic scenarios: China most vulnerable



Source: Baur et al. (2023), ifo Trade Model

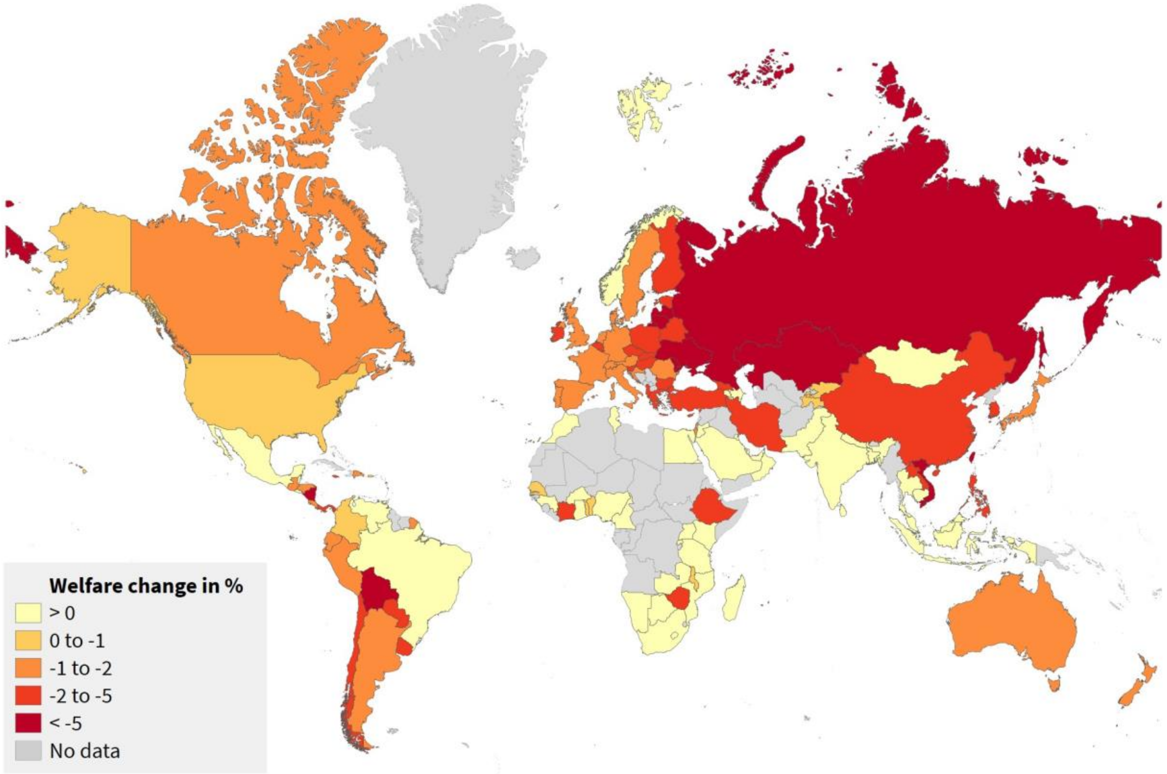
Effects on real income for different geoeconomic scenarios

UNILATERAL EU RESHORING (SCENARIO 1)



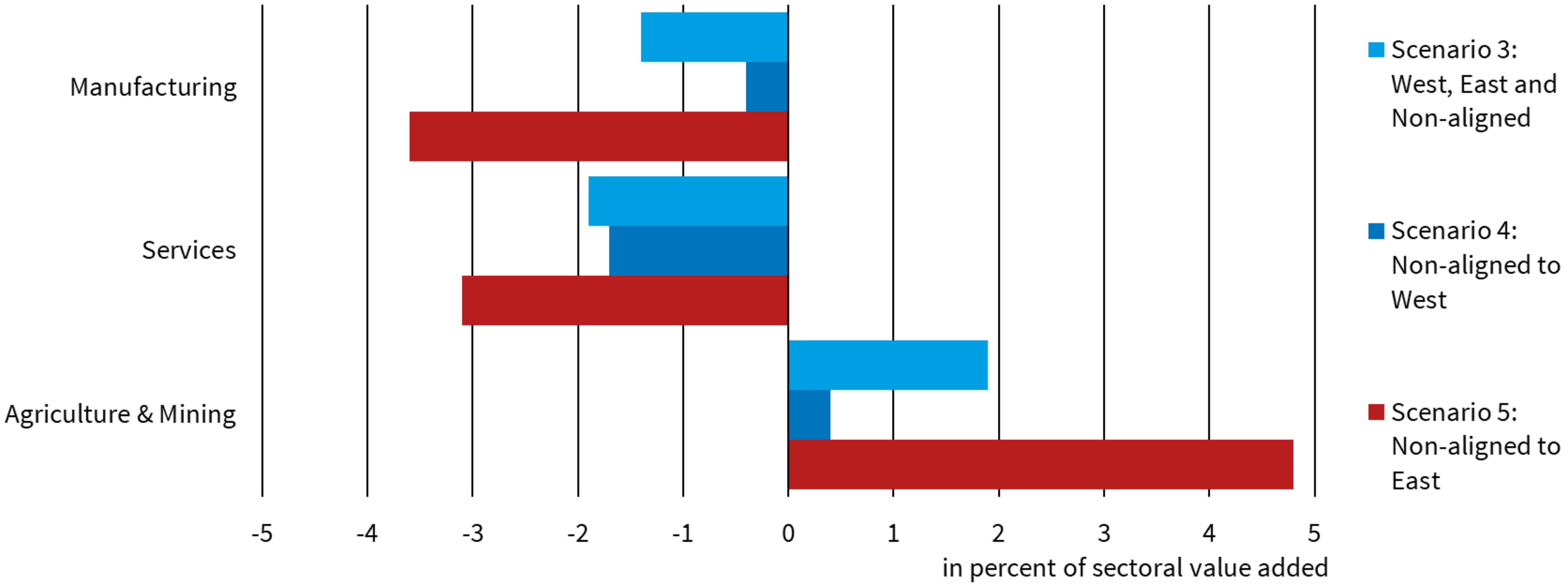
- Small open EU economies (e.g. Malta, Luxembourg, Belgium) suffer most

INCOMPLETE GEOECONOMIC FRAGMENTATION (SCENARIO 3)



- Welfare losses of Eastern bloc larger than for Western bloc
- Non-aligned countries slightly benefit due to trade diversion

Long-term effects of geoeconomic fragmentation for EU sectors



Source: Baur et al. (2023), ifo Trade Model

Conclusions

- Geoeconomic fragmentation may reduce EU real income by 1 to 5 per cent, depending on scenario (‘lower bound estimates’, abstracts from transition)
- If the West manages to maintain integration with ‘non-aligned countries’ (and between the US and the EU), the cost of trade frictions will remain limited
- As trade partner the ‘West’ is more attractive for ‘non-aligned’ countries than the ‘East’
- Reshoring is very costly: There is a risk that an increasing number of sectors lobby successfully for reshoring subsidies / protection from foreign competition (everybody claims to be ‘critical’ or ‘strategic’)

THANK YOU!

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