EDITORIAL

TO FRAGMENT OR NOT TO FRAGMENT (THE GLOBAL ECONOMY), THAT IS THE QUESTION

Would you expect a politician who promises to raise taxes on both households and corporates as a key plank of their growth strategy to get elected? Or the Parliament of an EU member state to vote against an EU initiative to cut such taxes? Probably not. And yet both just happened, with Donald Trump and fellow Republicans taking control of both the White House and Congress, and the French Parliament voting against the EU-Mercosur trade deal.

Tariffs are taxes, but unlike taxes, they and other trade restrictions have a mysterious and, these days, wide appeal in public opinion and the political class. Mysterious because they nearly always do more harm than good: in the near-term, causing price increases that transfer money from domestic consumers and corporates to the government (in the case of tariffs) or to domestic producers of the tariffed goods (in the case of non-tariff barriers); in the longer term, by incentivizing an inefficient allocation of productive resources (both labour and capital) and reducing the scope for technology transfers, both of which lead to productivity losses, as well as by reducing choice for buyers and growth opportunities for producers. This is not just what economic theory predicts, but also what an ocean of empirical research confirms.[1]

Why, then, are trade restrictions back in fashion (see *chart*)? A longstanding reason is that trade liberalization, while economically beneficial to the vast majority, sometimes does hurt some segments of society, notably companies facing little competition and less efficient ones, along with the workers they employ; that is a feature, not a bug. But these minorities tend to be more vocal and better-organized than the beneficiaries. They can be compelling in drawing sympathy from the broader population and hence win support from part of the political class, notably self-branded anti-establishment politicians, who have been on the rise across the world. In addition, more recently, the unprecedented supply-chain disruptions experienced during the COVID pandemic brought to light the vulnerabilities created by the long and intricate supply chains that have come to dominate production processes for large swathes of industry.

THE NUMBER OF GLOBAL CURRENT TRADE RESTRICTIONS WORLDWIDE

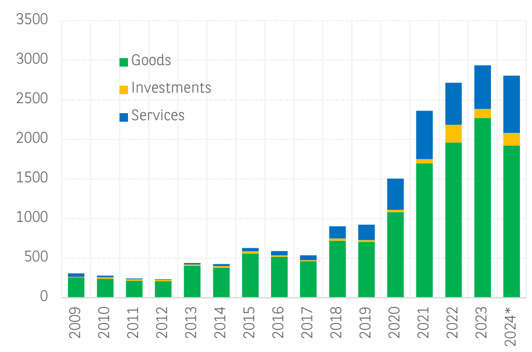

CHART 1

* JAN. 2024 -NOV. 2024
SOURCE: GLOBAL TRADE ALERT, BNP PARIBAS

Economic security became a new policy priority for governments around the world, soon followed by economic sovereignty in the wake of Russia's invasion of Ukraine and the US's new doctrine for managing its rivalry with China. While legitimate conceptually, these two motives have an ill-defined scope and, as such, have provided new fertile ground for trade barriers, on top of the longstanding internationally recognized allowance for remedial tariffs in the face of unfair practices such as dumping or subsidies, back in vogue too.

1 See Geoeconomic Fragmentation and the Future of Multilateralism, IMF Staff Discussion Note, 2023, for a discussion of the global evidence and bibliography. The Economic Impacts of the US-China Trade War, NBER, December 2021; and the Brexit Analysis section of the website of the Office for Budget Responsibility.

> Unsurprisingly, unelected policymakers have been the first to plead against trade retaliation, and deserve credit for doing it so soon and so clearly in recent days.

Against this backdrop, what is the best response to the new tariffs that the US President may decide to impose? Let's leave aside here the question of negotiating posture. It has been argued, including by the nominee for Treasury Secretary-- that President-elect Trump holds the threat of tariffs as a useful negotiating tool to achieve other aims, e.g., related to immigration or security policy, more than a goal in themselves. It's also been argued, from the other side, that a threat of tariff must be met by an equally strong threat of retaliation, as a matter of both negotiation strategy and meeting the presumed expectations of voters. But let's assume additional tariffs are actually imposed by the US. What, then, is the best response? Again, the analytical evidence points overwhelmingly to not retaliating via trade restrictions, as doing so would only fragment the global economy, whether wholly or even into blocks, and such fragmentation would have tremendous costs for all parties involved.

Unsurprisingly, unelected policymakers have been the first to plead against trade retaliation, and deserve credit for doing it so soon and so clearly in recent days. Building on extensive work done by the International Monetary Fund (IMF) already for a couple of years, Andrew Bailey, Governor of the Bank of England, went on the record first[2], soon followed by the ECB's Philipp Lane[3] and Christine Lagarde[4]. One must hope many will follow and that their voices will be amplified by those most at risk from economic fragmentation (notably globally-engaged manufacturers), and ultimately heard by the elected policy-makers who will determine the actual response.

Estimates of the costs of fragmentation vary in amplitude, but they are invariably large. The ECB[5] estimates the costs of fragmentation of global trade range from 2% of global GDP in a scenario of mild decoupling (partial barriers on all sectors) to 5.5% if full trade bans are added in selective sectors and 9% in the case of full trade ban on all sectors. The orders of magnitude are the same in terms of impact on Europe's GDP. Earlier work by the IMF[6] found similarly large output losses in the event of a fragmentation of global trade into four blocks, with the more open economies most negatively impacted. Estimates in the broader economic literature surveyed by the IMF are wide-ranging but could be as high as 12% of global GDP over the long run.[7]

Much better for the US's trading partners to pursue self-help instead of self-harm, i.e., forego retaliatory tariffs and instead deepen trade integration with willing counterparts. They should also pursue the domestic policies they know they need to boost their growth and competitiveness. For Europe and the UK, this means reducing internal barriers (both within EU –recent IMF estimates indicate reducing internal market barriers to the level of the US would boost productivity by 7%[8]--and between UK and EU) and boosting investment, both public and private. For China, this means strengthening domestic demand, especially consumption, to counter the fast-declining rate of return of capital investment.

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2 Trump Tariffs Should Not Prompt UK Retaliation in Kind, Warns BOE's Bailey - Bloomberg.
3 Navigating a fragmenting global trading system: insights for central banks, 21 November 2024.
4 Christine Lagarde interview, Financial Times, 28 November 2024.
5 Navigating a fragmenting global trading system: insights for central banks, op. cit.
6 Geoeconomic Fragmentation: What's at Stake for the EU, IMF Working Papers, November 2023.
7 Geoeconomic Fragmentation and the Future of Multilateralism, op cit.
8 Europe's Declining Productivity Growth: Diagnoses and Remedies, IMF Regional Economic Outlook, November 2024, Note One.