Euro Area Risks Amid U.S. Protectionism

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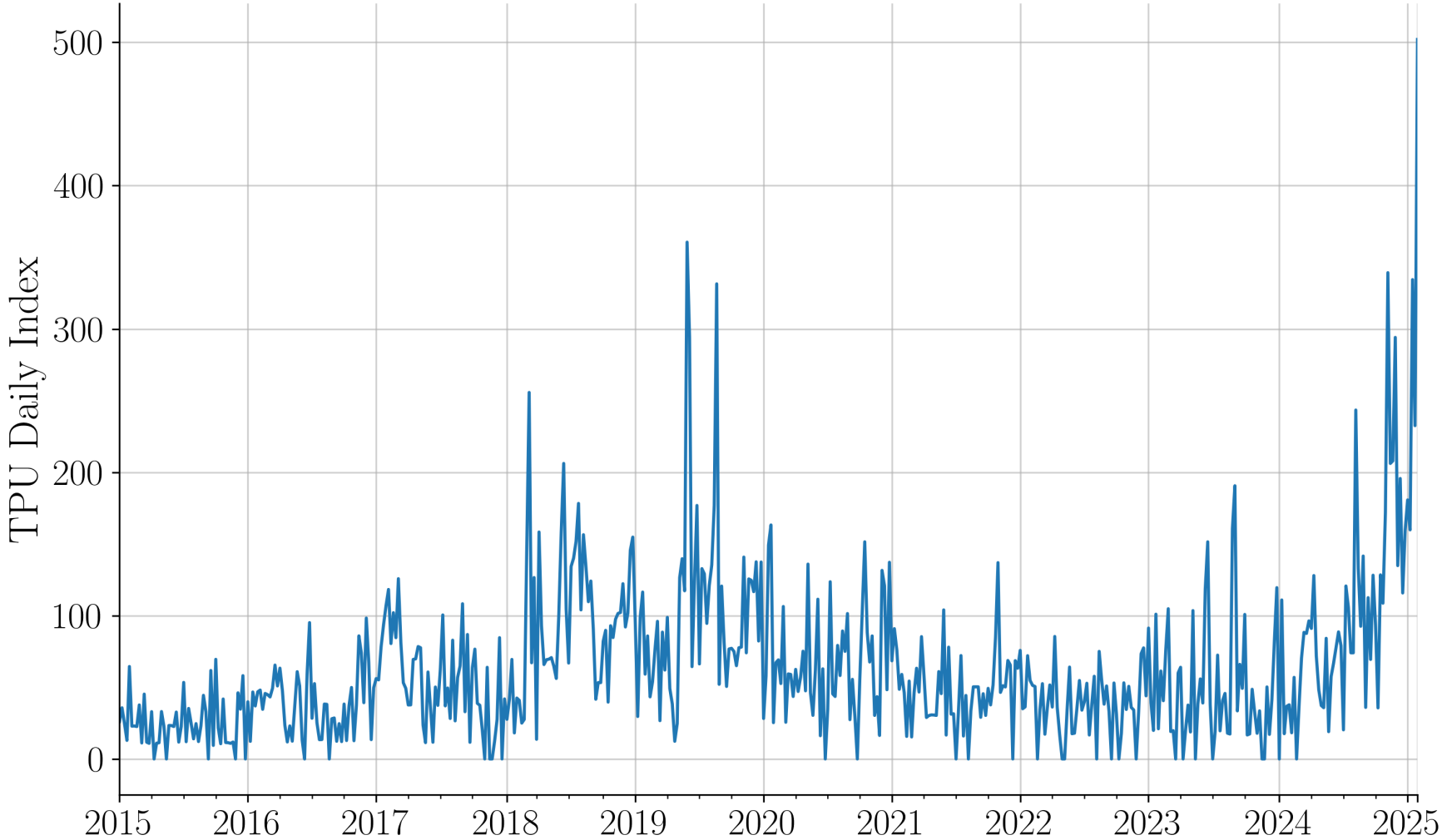
https://www.europarl.europa.eu/committees/en/econ/econ-policies/monetary-dialogue

The BIG Picture



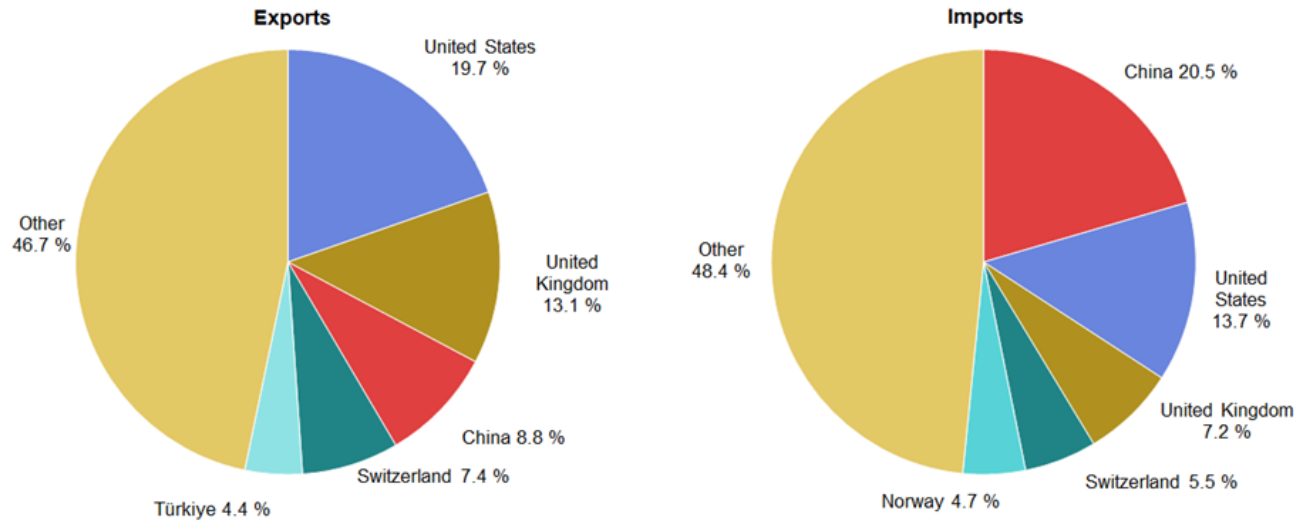
https://www.matteoiacoviello.com/tpu.htm

Tariff Shock

- Direct Effect
  - Direct effect of US tariffs on EA exports could be mitigated by euro depreciation
  - US tariffs on China may redirect Chinese exports to EA and have additional impact on EA economy
- Overall effect of US tariffs depends on
  - policy response: restrictive monetary policy or retaliatory protectionist measures could exacerbate downturn
  - uncertainty on the conduct of economic policy and on the fiscal side.
  - Increased risk premia on long-term US bonds may translate in higher borrowing costs for EA, limiting fiscal flexibility

EU Trade Partners

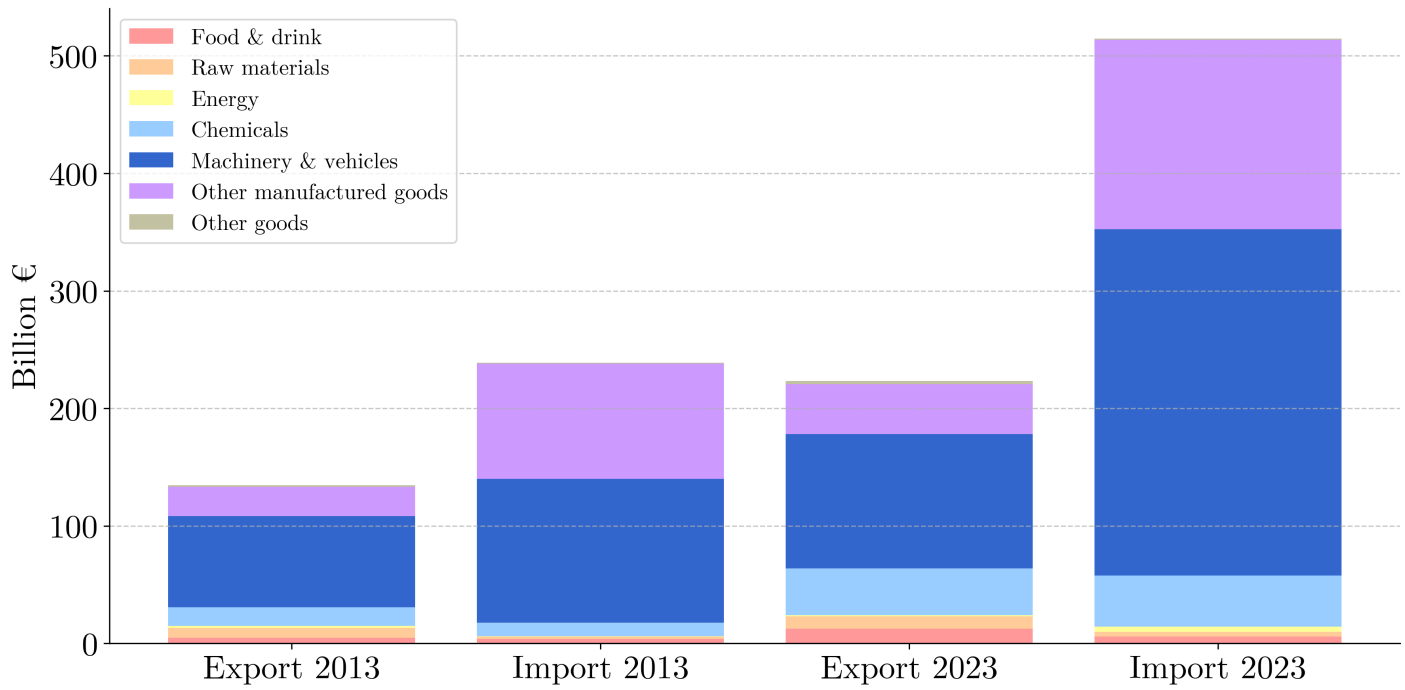
The United States among the EU's main partners for trade in goods, 2023
(% share of extra-EU exports/imports)



Source: Eurostat (online data code: ext_st_eu27_2020sitc)

eurostat

EU Trade with China



US Tariffs without retaliations

- Direct effect: reduction in EA exports to US
- Depreciation of the Euro: reduced exports mean lower demand and expansionary monetary policy (if not fighting trade imported inflation)
- Trade diversion from China
- Larger depreciation of the yuan that translates into appreciation of euro vs yuan

Effects of US protectionist measures on EU aggregate demand, back-of-the envelope estimates

	1. Direct effect	2.Exchange rate vs. US	3. Trade diversion from China	4. Exchange rate vs. China	Total
EUR billion	-137.5	+34.4	+10	-35.	-127.5
% GDP	-0.88%	+0.22%	+0.07%	-0.20%	-0.80%

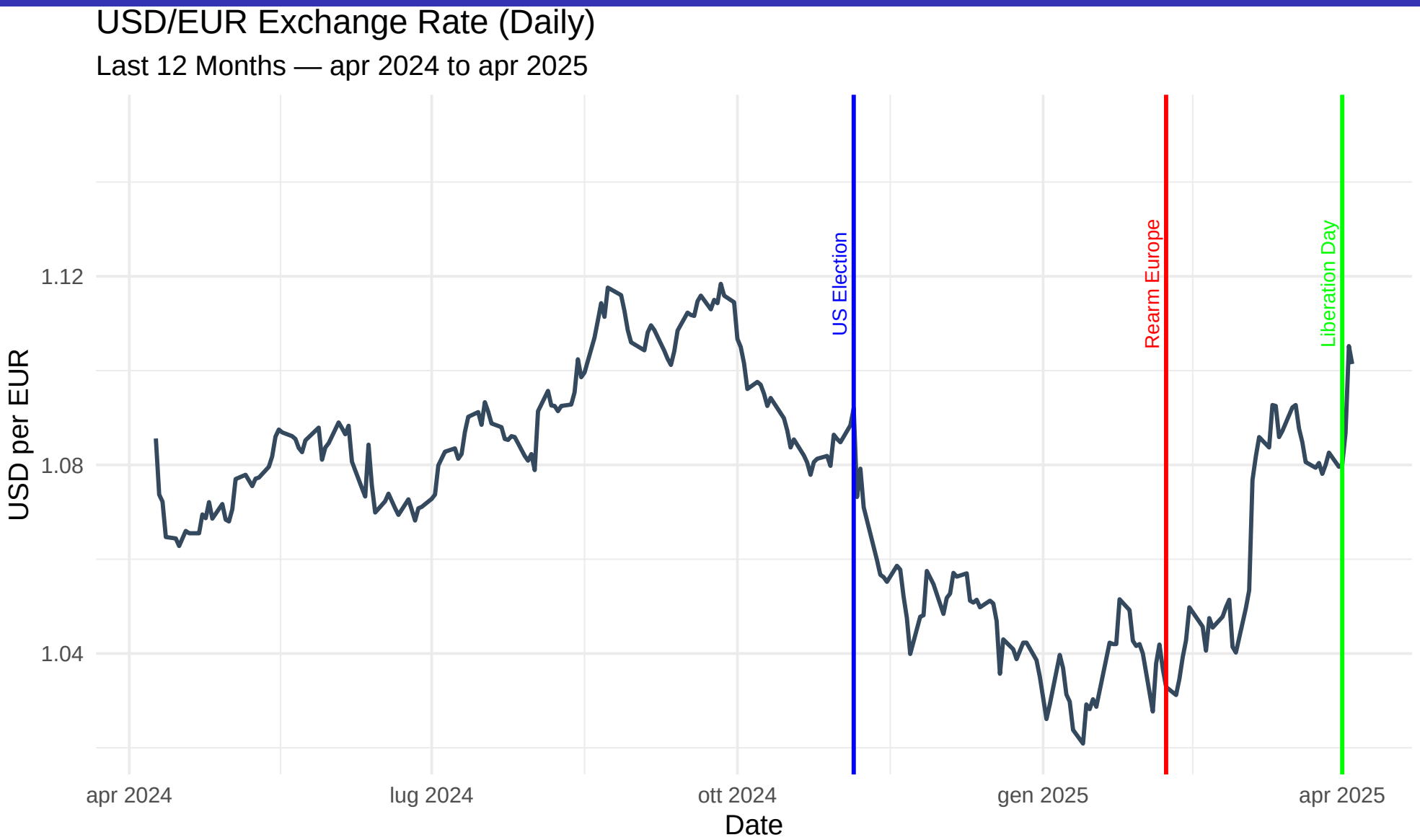
Note: Assume 20% tariff increase on European goods, 34% on Chinese goods, trade elasticity to tariff of 2, elasticity of import/export to exchange rate of .5

Why is the Direct Effect Moderate?

$$(S - I) + (T - G) = (X - M)$$

- The euro area tends to run a trade surplus, which means that domestic savings exceed investment.
- The excess of private domestic savings on investment is driven by fundamental trends, for example, demographic trends: Europe has a relatively larger share of older people who, empirically, tend to save more.
- As these trends are not affected by tariffs Most economists believe the effect of tariffs, their effect on the trade deficit cannot be large.
- US tariffs on euro area imports directly reduces US imports from the euro area. However, a concomitant depreciation of the euro partly undoes this, by making European goods cheaper for US consumers, and, at the same time, it makes US goods more expensive for European consumers.

Exchange Rate Fluctuations

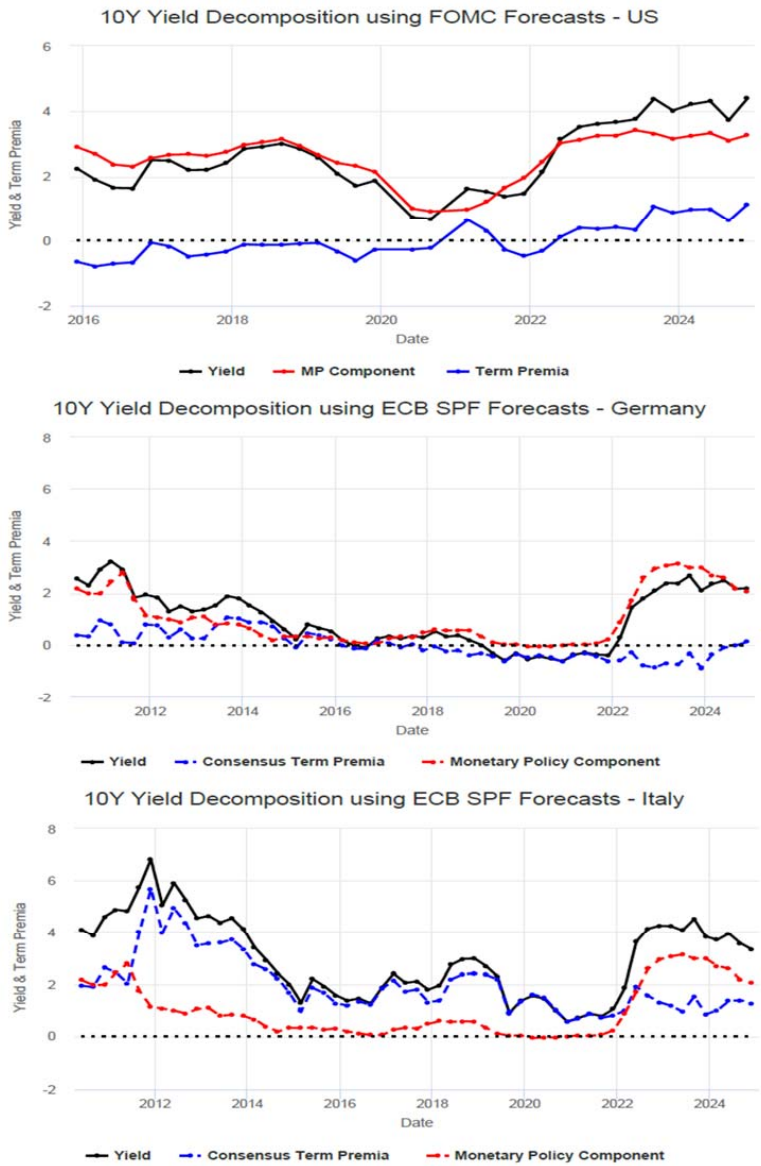


Fiscal Policy and the Bond Market

- US side: a fiscal contraction highly unlikely tariffs' revenues are not going to be enough to cover tax cuts
- This is consistent with rise in long term yields on US Treasuries, mostly due to term premia
- EU side: new fiscal expansionary environment Increase in defense spending
- For ECB change in policy mix. Easier to deal with demand contraction from US, but now underlying inflationary forces. Stronger EUR/USD ok in this scenario
- Main challenge for EU: financial contagion on long-term yields can make borrowing more costly

Bond Yields

Figure 9: Decomposing yields into term premia and monetary policy components



Source: authors own computations

Tariffs and Monetary Policy

- Effects of **tariffs** through the lens of a workhorse open economy **New Keynesian model**

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- Macroeconomic effects of tariffs crucially depend on systematic monetary policy behavior
- Key role of endogenous exchange rate response

Tariffs and Monetary Policy

- Summarize the **output effect** of tariffs in one equilibrium equation

$$y_t = \underbrace{-\Omega_y \mathbb{E}_t \sum_{j=0}^{\infty} \left(i_{t+j} - \mathbb{E}_t \pi_{H,t+j+1}\right)}_{\text{endogenous monetary policy effect}} + \underbrace{\Omega_M T_{M,t}}_{\text{import tariffs}} - \underbrace{\eta\gamma T_{X,t}}_{\text{export tariffs}}$$

$$\Omega_M > 0$$

if trade elasticity of substitution sufficiently high

Import Tariffs: Does the "Protectionist Argument" Hold?

- **Benchmark** result under PPI-inflation targeting (= **flexible** domestic prices)
  $\rightarrow$ Import tariffs **can** have an **expansionary** effect on domestic activity - by redirecting demand towards domestic goods - if **trade elasticity** of substitution is sufficiently high.

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- **CPI-inflation targeting** has "tightening bias" $\Rightarrow$ Leads central bank to counteract tariff-induced CPI increases with **interest rate hikes**, offsetting stimulative impact on output.
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- Exchange rate targeting → Amplifies **expansionary effects** of import tariffs.
  - Fixed nominal interest rate → Prevents tightening + ex. rate appreciation altogether
  - Comes at the cost of a **sharp rise** in CPI and PPI inflation.

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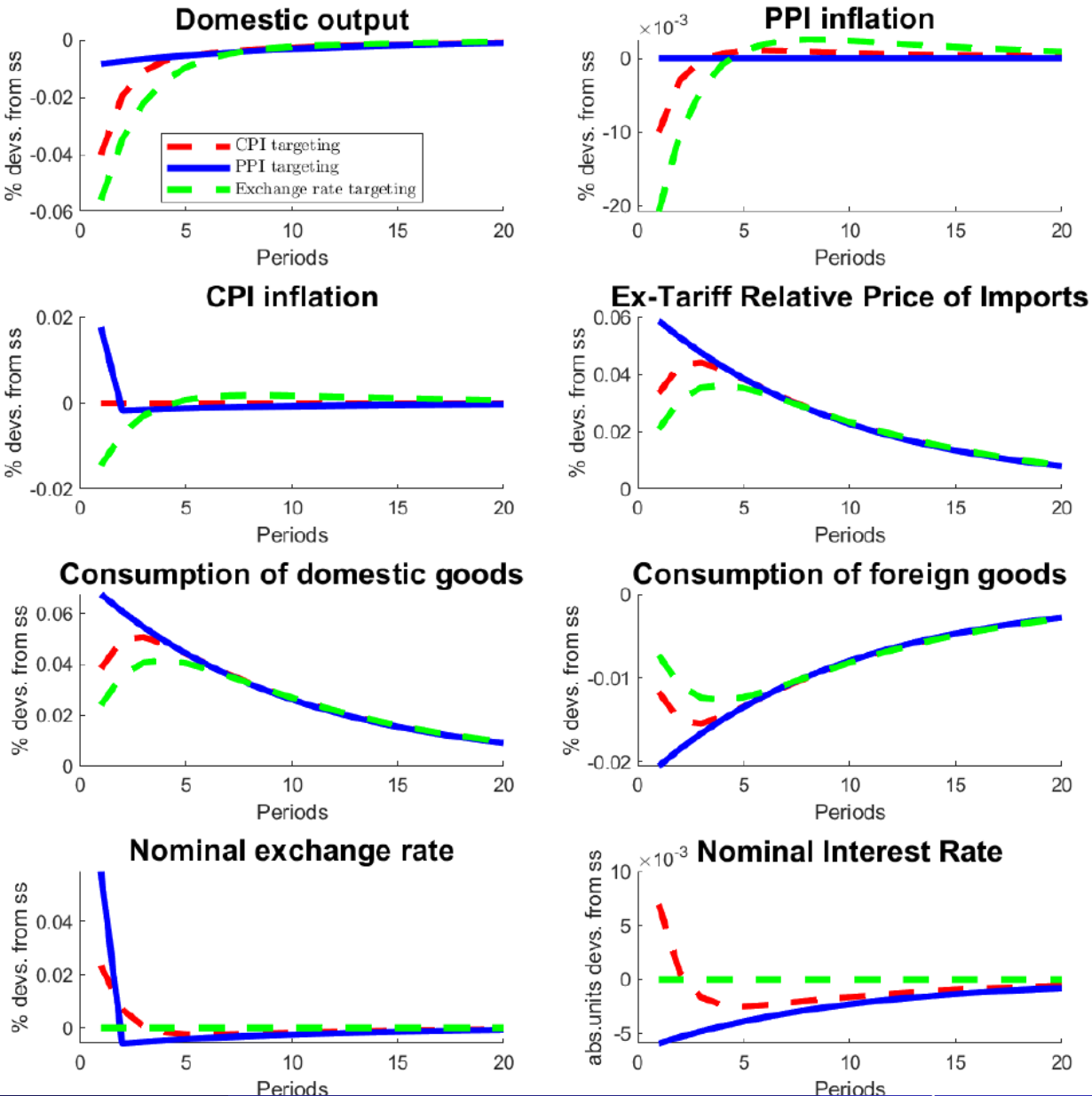
- **CPI-inflation targeting** entails a partial degree of leaning against exchange rate depreciation $\rightarrow$ Amplifies contractionary effect on domestic output relative to PPI targeting.
- **PPI-inflation targeting** results in the **mildest contraction** in economic activity, as it involves the least degree of leaning against the ensuing exchange rate depreciation.

Impulse Responses to 20 percent Export Tariff Shock



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- Export tariff shocks: social planner **amplifies ensuing depreciation** of the relative price of imports.
- By manipulating international relative prices, social planner can provide a **boost to domestic economic activity** relative to **inward-looking** policy of stabilizing inflation in **sticky** domestic goods prices.