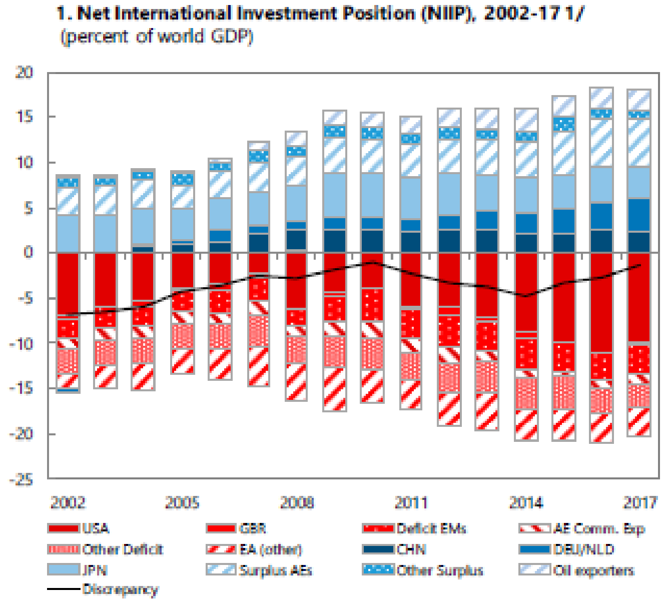
Global Imbalances and Trade War

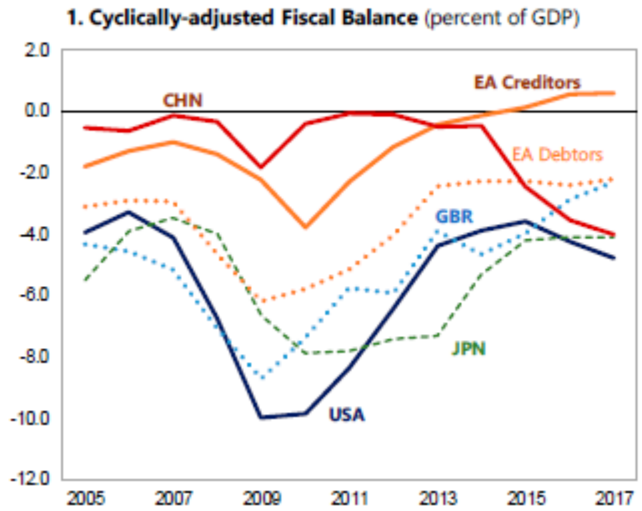
Barry Eichengreen

July 2019

- Global imbalances remain a fact of 21st century life.
- As you can see here.



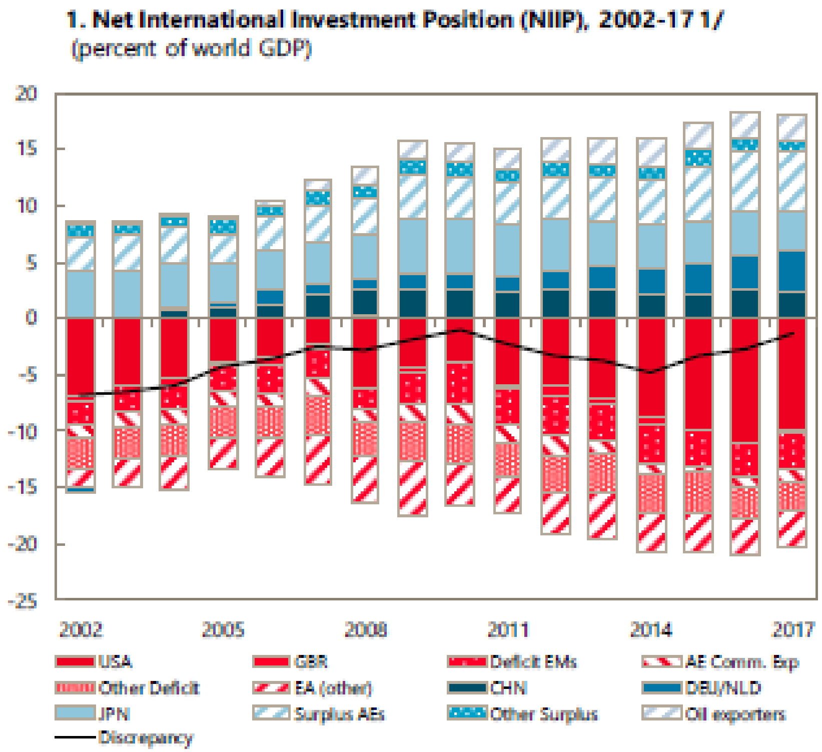
- As some countries, starting with the United States, do everything they can to aggravate them.
  - Through their discretional fiscal actions.



That said, I do not entirely agree with the premise of this session

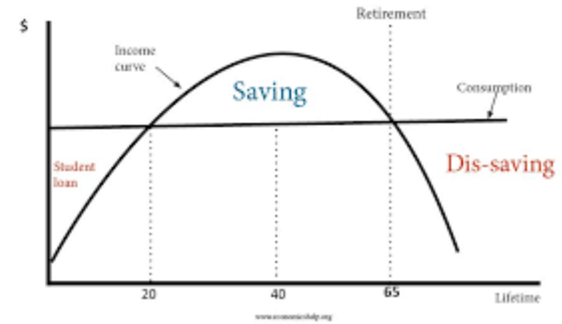
- "As we are entering the 75th year of the Bretton Woods system, global imbalances, despite the trend towards exchange rate flexibility, has not eliminated the occurrence of these and the build-up of international reserves. It may reflect a lack of adjustment mechanisms. Global stock positions have continued to widen as stated in the G20 communique. These imbalances have generated threats of currencies and trade wars which could undermine the stability of the international monetary system."

- First, sustainability is not a pressing issue from an economic point of view.
- Given the current configuration of imbalances and America's exorbitant privilege.
- From a political point of view, the current configuration may be more of a problem, of course.
  - An interesting question is whether this is a Trump-specific problem (that could end in 2021).
  - Or whether it will remain a problem because of the advent of "a new Cold War."



Moreover, current account balances simply reflect national savings and investment rates

- There is of course no reason that these should trend toward equality at the national level.
- Countries with higher old-age dependency rates will save less.
- Countries with faster economic growth will save more.

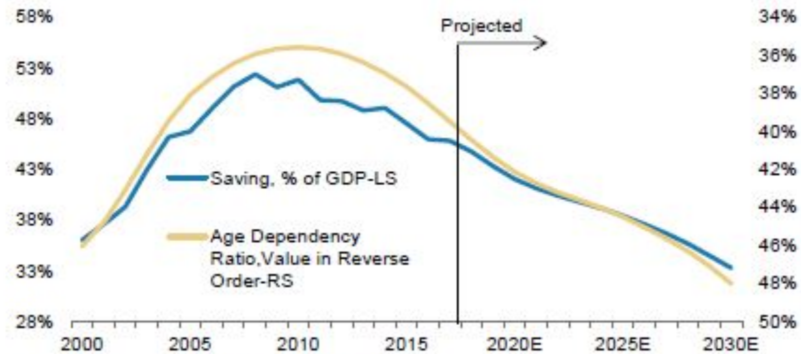


Moreover, current account balances simply reflect national savings and investment rates

- There is of course no reason that these should trend toward equality at the national level.
- Countries with higher old-age dependency rates will save less, chronically.
- Countries with faster economic growth will save more.
- And China's savings rate has come down, consistent with these facts.

Exhibit 10:

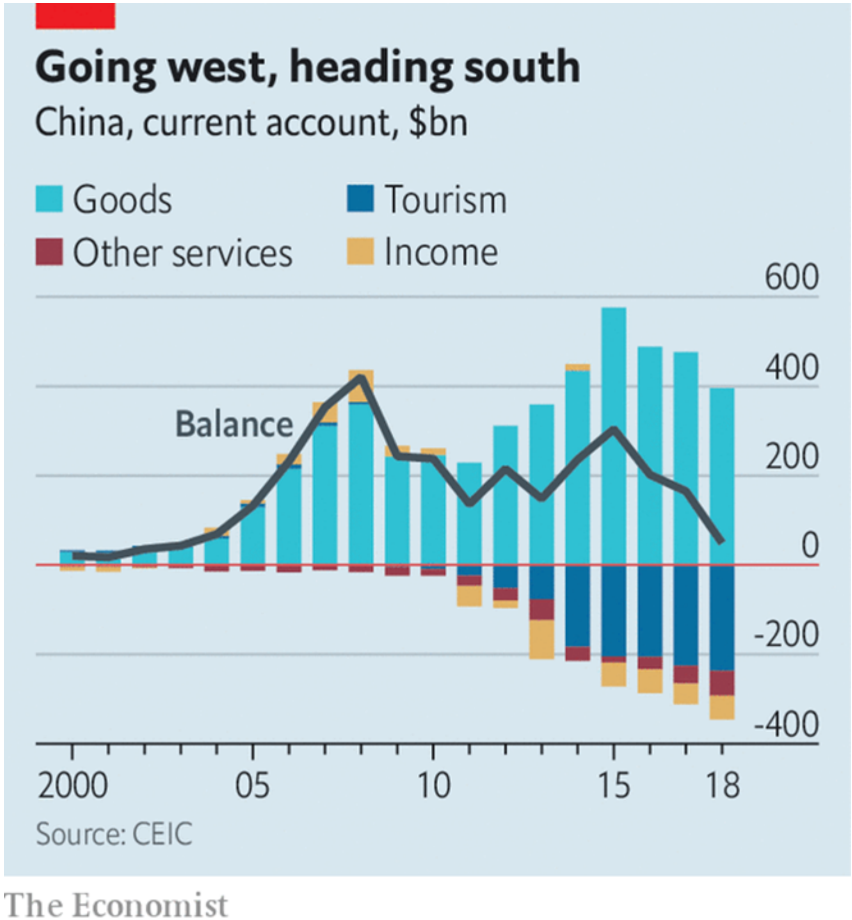
Slipping saving rate amid aging population...



Source: CEIC, Morgan Stanley Research forecasts

Current account surpluses and deficits reflect savings and investment rates

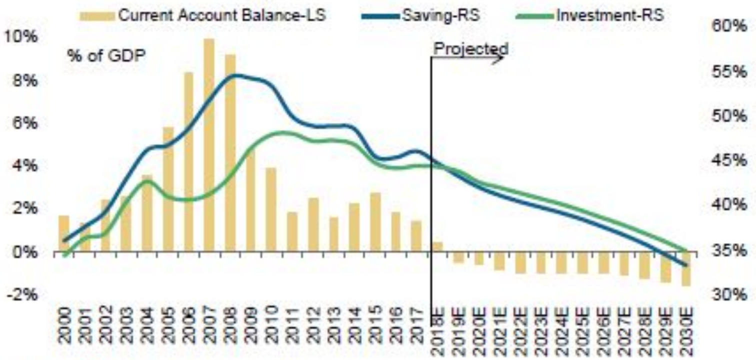
- There is of course no reason that these should trend toward equality at the national level.
- Countries with higher old-age dependency rates will save less, chronically.
- Countries with faster economic growth will save more.
- And China's current account surplus has come down, consistent with these facts.
  - Though that the trade surplus is largely offset by a tourism deficit creates something of an optic problem for a manufacturing-focused US president.



- China’s investment rate will come down as well, of course.
- Since no country can invest 50% of GDP productively forever.
- And demands for social spending will intensify with middle-income status.
- Still, there is an irony in the fact that that Trump has launched his trade war against China precisely when the problem is going away.
- All of which is a reminder that, in reality, that war is about more than trade, or about global imbalances.

Exhibit 11:

...to lead to a structurally weaker current account balance in China



Source: CEIC, Morgan Stanley Research forecasts

So what effects will the trade war have in this context?

- To a first approximation, none.
- Since tariffs won't affect S and I, they won't affect current accounts.
- The exchange rate will simply adjust to offset their impact on relative prices.
- This is where I came in. (Although the point was made even earlier by Mundell 1961).

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A dynamic model of tariffs, output and employment under flexible exchange rates

Barry J. Eichengreen *

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Abstract

A portfolio balance model of the open economy with imperfectly flexible wages and rational expectations is used to analyze the macroeconomic effects of commercial policy. Previous analyses have led to the 'counterintuitive' and 'almost inconceivable' conclusion that, under flexible exchange rates, a tariff is contractionary. By considering a tariff in a dynamic setting and focusing on the process of adjustment, it is shown that there may exist a tradeoff between a tariffs short-run and long-run effects. In certain circumstances, a tariff imposed under flexible exchange rates increases output and employment initially while reducing them subsequently.

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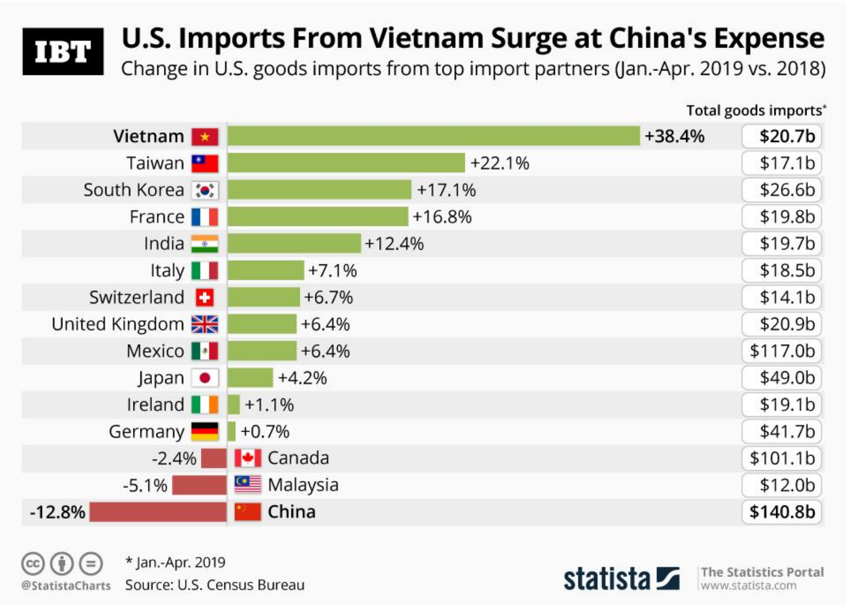
In a multilateral world, there will also be some redirection of trade

- US will import from Vietnam rather than China.
- China will boost its exports to Vietnam's other markets.
- (To the extent that Vietnam's increased exports to the US represent more than relabeling.)



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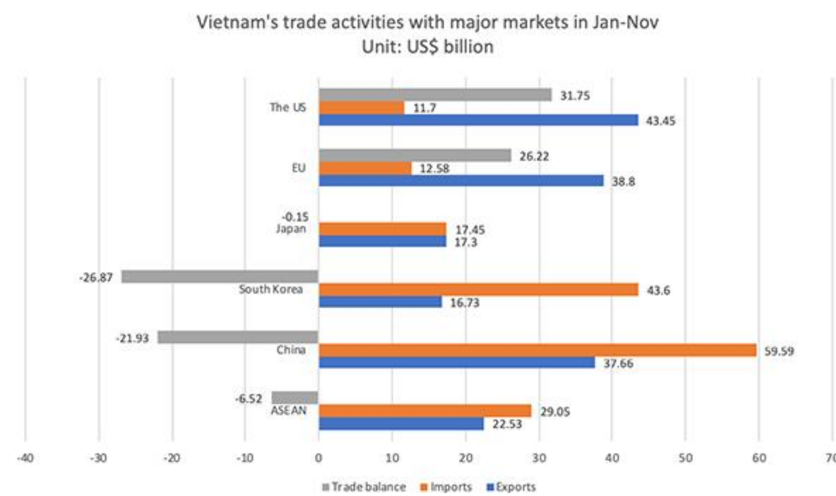
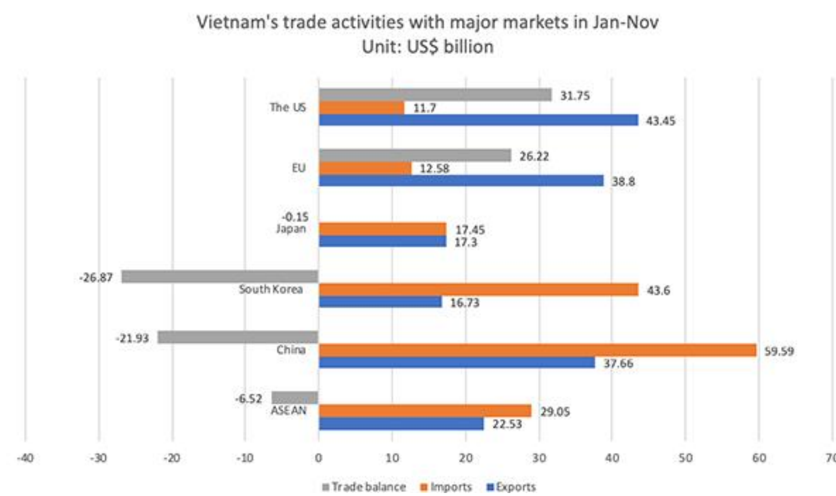


In a multilateral world, there will also be some redirection of trade

- US will import from Vietnam rather than China.
- And Trump has noticed: he has suggested that Vietnam's exports to the US are "even more unfair" than China's.
- And the US has imposed 400% (!) tariffs on steel from Vietnam.



Should we care about this?

- We can think of this in terms of customs union theory (where customs unions give rise to both trade creation and trade diversion).
- Here we have:
- 1) Destruction of a customs union between the US and China (a CU that arguably gave rise to more trade creation than trade diversion).
- 2) Creation of a customs union between China and non-US ROW, as China actively reduces its tariffs against non-US ROW (and whether this one will give rise to more trade creation or trade diversion is yet to be determined).

Subtler effects

- Negative effect on investment in the U.S., leading to smaller current account deficit?
  - May be evident, but signals are mixed.

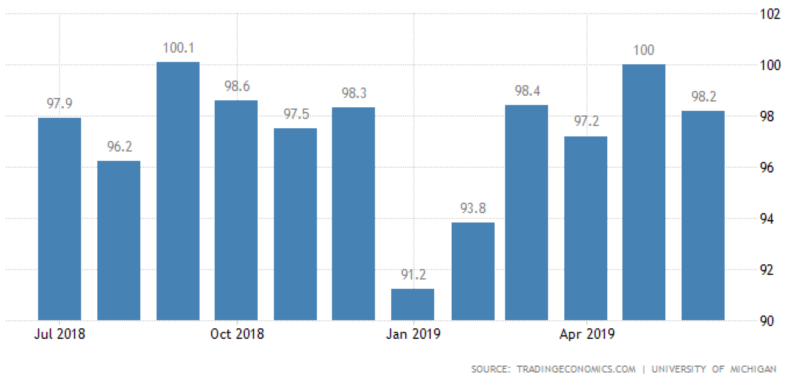
- Yahoo Finance:

  - “On Jun 26, the Department of Commerce released U.S. factory orders for long-lasting durable goods in May. Although the orders contracted, the rate of decline was much less than the previous month.

    Moreover, core durable goods order –- a key metric to track business investment plan –- jumped significantly. The shipment of core durable goods also increased to a large extent in May. These two metrics provide a major relief to the market’s concern that investment softened in the manufacturing sector primarily owing to the lingering trade dispute with China.”

Subtler effects

- Negative effect on consumer confidence in U.S., leading to less consumer spending and higher savings rate/smaller current account deficit?
  - Not really evident yet.



Or CBs could take steps to prevent exchange rates from moving

- That what’s Trump’s talk about currency wars, criticism of Powell, and nomination of Shelton are all about.

Or CBs could take steps to prevent exchange rates from moving

- That what's Trump's talk about currency wars, criticism of Powell, and nomination of Shelton are all about.
- Although you've got to ask: what would the PBOC do in response to a Fed rate cut?

- Thank you.