REMARKS BY JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, ON "ATTACKS OF TARIFFS: WHAT ABOUT CURRENCIES?". EURO50 GROUP & CIGI MEETING. Bali, October 12, 2018.[1]

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Ten years after the outbreak of the financial crisis, the global economic recovery appears to have peaked, with GDP growth rates for this and the next couple of years projected to stabilize at levels similar to those recorded in 2017, and to decline subsequently to a less vigorous pace in line with lower potential rates of growth in many economies. Further to the envisaged loss of momentum going forward, a number of remaining legacies, as well as new perils, continue to tilt the balance of risks for the outlook to the downside.

Chief among the latter is the rising trend of protectionism, evidenced by more restrictive trade policy stances, both actual and intended, in a number of countries, leading in turn to heightened tensions or outright conflict between governments. Of course, the specific nature and extent of these tensions is varied and broad-ranging, and while there has been some relief in virtue of progress achieved in some particular cases, such as the recently announced agreements in the North America region and between the United States and Korea, ongoing hostilities in other fronts remain a major source of concern.

Of particular note is the clash between China and the United States, which is widely regarded as the one with the potentially direst consequences, not only for the economies directly involved but, also, globally. In fact, the performance

[1] The views and opinions expressed in this document are the sole responsibility of the author and do not necessarily represent the institutional position of the Banco de México or of its Board of Governors as a whole.

throughout this year of a number of variables points to the effects that such a situation may already be exerting on the world economy.

For instance, international trade volumes have notably slowed down relative to the upward trend they had displayed since 2015, while other indicators on the output side, such as export orders in global manufacturing PMIs, sentiment indexes for trade oriented sectors, and capital goods orders in some of the main economies, are showing a declining trajectory that, if sustained, would eventually be reflected in international trade figures.

Why is such a potential setback in global openness to trade so worrisome?

Naturally, the complexities of the trade and financial networks and interlinkages embedded in the global production framework, give rise to a multiplicity of channels through which higher tariffs and other protectionist measures can affect the world economy.

Directly, the cross-border flow of goods and services (a long-standing engine of growth for both national and the world economies) would be severely hindered by the increased costs resulting from such policies. The situation is particularly worrisome in the case of intermediate goods and services, given the relevance they have come to acquire in the current context of global value chains (GVCs).

Indirectly, the uncertainties derived from such a retreat from globalization and free trade may have an adverse impact on business and household confidence, thereby leading the former to postpone or scale back investments plans for new or expanded production, and the latter to follow suit in regards to their planned consumption expenditure paths. Furthermore, an environment of heightened protectionism has the potential to impinge on financial conditions, given the resulting increase in the perception of risk among market participants.

Arriving at an accurate, exhaustive assessment of the macroeconomic implications of a more restrictive environment for international trade is a complex task. However, some of the potential implications are evident.

First, activity levels in both countries directly involved and the global economy would take a significant hit from an escalation of trade conflicts. In the case of tariff-imposing countries, and their retaliating trade partners, higher import prices harm firms by increasing their production costs, and households by decreasing their purchasing power and disposable income. Thus, GDP is weighed down by the combined declines in both consumption and investment. Further to this, aggregate demand from these sources can also be affected by the above-noted detrimental consequences deriving from a loss of confidence and tighter financial conditions. As for countries not directly involved in a trade dispute, the impact on their economies would depend on a number of factors, including their size, openness to trade, exposure to countries imposing tariffs, and degree of integration into GVCs, among others. Although it may be argued that some of these countries could be in a position to reap benefits from a potential diversion of trade flows, the net effects from such a restrictive environment are most likely to be negative.

Secondly, further to the short-term effects on the *level* of GDP noted above, trend *growth* over the long run is likely to fall as well, once the global economy adjusts to a higher-tariff environment. This is explained partly by the undermined efficiency with which labor, capital, and other factors of production are allocated under conditions of lessened competition and more restricted access to global markets, thereby inhibiting the innovation process and the consequent gains in productivity, a fundamental driver of growth. In addition, higher trade barriers also hamper to a significant extent the international transfer of technology, know-how and best business practices, foundations on which emerging and developing economies are particularly reliant. To the above one must add the adverse effects on confidence and financial conditions. In this respect, it may be useful to note that one of the main reasons behind the stagnation of private investment in my country for a significant period already, is precisely uncertainty related to trade negotiations with the United States and Canada.

Thirdly, notwithstanding weakened demand pressures arising from subdued levels of activity, inflation is likely to adjust to the upside under a more protectionist environment. Further to the direct effects on imports prices brought about by higher tariffs, less competition from abroad in labor and goods markets pushes domestic prices and wages upwards, while the above-noted efficiency losses on the supply side of the economy (including those resulting from the potential disruption of GVCs) should act in a similar way. In fact, we must not forget that the effect of international trade on competition and production costs is one of the major explanatory forces for the period of low inflation that we have seen at the global level in recent years.

As noted earlier, the hard evidence that to date can be gathered regarding the impact of the ongoing episode of increased protectionism in the global economy is still scant. If any conclusion can be drawn, it is that said effects have been relatively small, albeit not insignificant and definitely not to be overlooked.

Emerging market economies (EMEs) have faced tighter (and tightening) external financial conditions over the last several months, which have translated into declining capital inflows and the consequent pressures on their exchange rates. In addition to specific, idiosyncratic factors that have been at play, especially in instances where episodes of acute stress have been present, this has reflected fundamentally the tightening of monetary policy by the Federal Reserve, in an environment of global uncertainty deriving from a combination of factors.

Obviously, a more restrictive trade policy stance in the United States and other countries has been one of them, although the extent to which this has affected different economies is varied. In this regard, it is again relevant to refer to the Mexican experience, where the trajectory of the exchange rate of the peso has been heavily influenced by news and expectations about NAFTA (now USMCA), in some episodes the single most important factor driving the value of our currency. In any case, trade policy shifts remain far from being the main determinant of exchange rates in EMEs in general. Nevertheless, it is also true that their potential to affect EME currencies and other financial variables should not be underestimated.

For the already explained reasons, trade-related events can severely distress the economic and financial prospects of EMEs. Furthermore, through its potential impact on inflation, protectionism may accentuate the challenges resulting from the ongoing normalization of monetary policy in a number of advanced economies. More generally, the potential for an increase in protectionism to a level implying systemic risks at the global level is a scenario that cannot be discarded.

The exercises carried out by a number of institutions on the impact of higher levels of protectionism depict a grim picture. For instance, recent simulations by the IMF[2] suggest that, in a high-tariff scenario compounded by adverse confidence effects and tighter financial conditions, the net negative impact on the level of global GDP peaks at about 0.8 percent below the baseline trajectory in 2020. The accumulated output losses over 2018-2023 amount to around 3.2 percent of world GDP. To have an idea of the order of magnitude of this figure, suffice to say that it compares with the G20 objective of raising these countries' collective GDP by 2 percent above baseline over the five years to 2018, and that it is roughly equivalent to the size of Germany at present. Additionally, it is worth highlighting that, according to these results, none of the considered countries or regions benefits from such a situation, although some lose more than others.[3]

Notwithstanding the rigor with which these models are devised, we must not forget that they face severe limitations when trying to capture the effects of high levels of uncertainty. Furthermore, it is also important to bear in mind

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[2] See International Monetary Fund (2018): "Global Trade Tensions", Scenario Box 1 in Chapter 1 of *World Economic Outlook*, October.

[3] Additional estimates of the macroeconomic implications of more restrictive trade policy stances can be found in Allan Gloe Dizioli and Björn van Roye (2018): "Macroeconomic Implications of Increasing Protectionism", ECB Economic Bulletin Issue 6/2018, 26 September; Mark Carney (2018): "From Protectionism to Prosperity", Speech given at the Northern Powerhouse Business Summit, 5 July; Zornitsa Kutlina-Dimitrova and Csilla Lakatos (2017): "The Global Costs of Protectionism", World Bank Policy Research Working Paper No. 8277, December; and Organisation for Economic Co-operation and Development (2016): "The Impact of Changes in Global Trade Costs", Box 1.3 in Chapter 1 of *Economic Outlook*, November.

that a burst of protectionist actions would hardly take place in isolation. Most likely, it would be accompanied by other negative events, such as currency wars, the implementation of inward looking policies in other areas and an additional backlash against globalization. In light of these considerations, it would be reasonable to take quantitative exercises like the ones described above as conservative estimates, or rough qualitative guides as to what we may face going down this path.

Indeed, it is difficult to understand why the world economy is again facing such high stakes, after the experience with protectionism during the Great Depression of the 20th century, and with the burden of the global financial crisis still present in many economies.