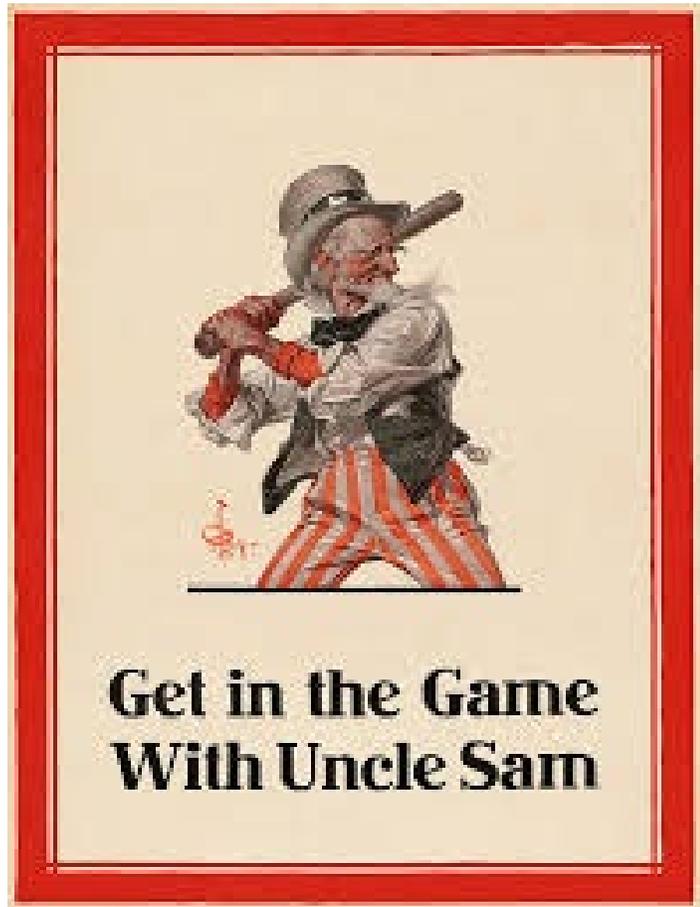
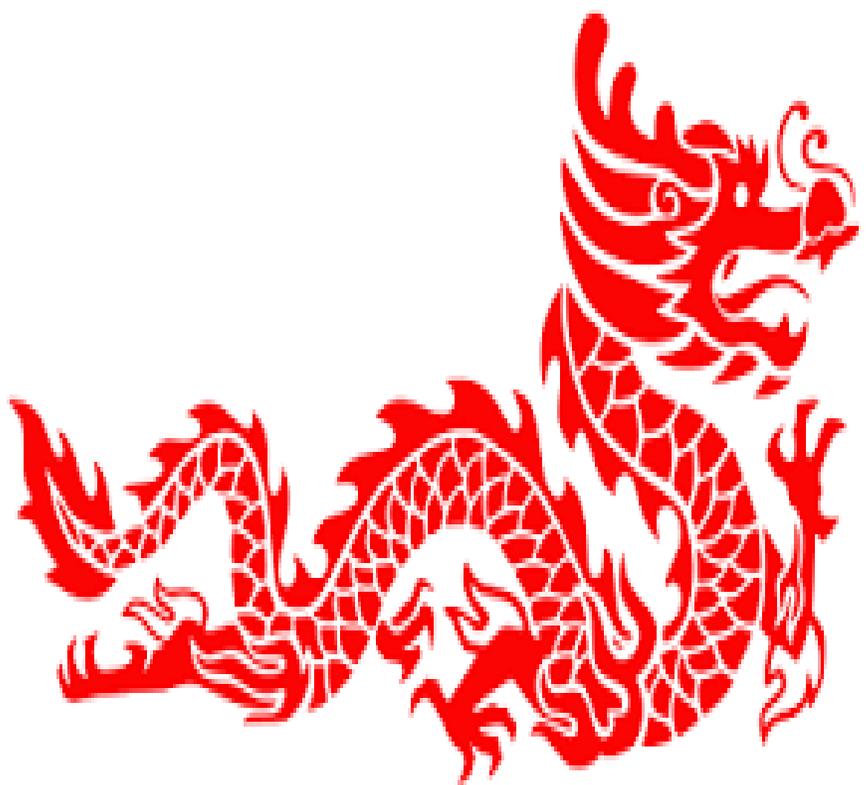


Bocconi

MONETARY POLICY IN EUROPE: BETWEEN TRUMPIAN UNCERTAINTY AND INDUSTRIAL RESTRUCTURING

Daniel Gros
Keynote 52nd OeNB Annual Economic
Conference with SUERF
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Can Europe hold its own?



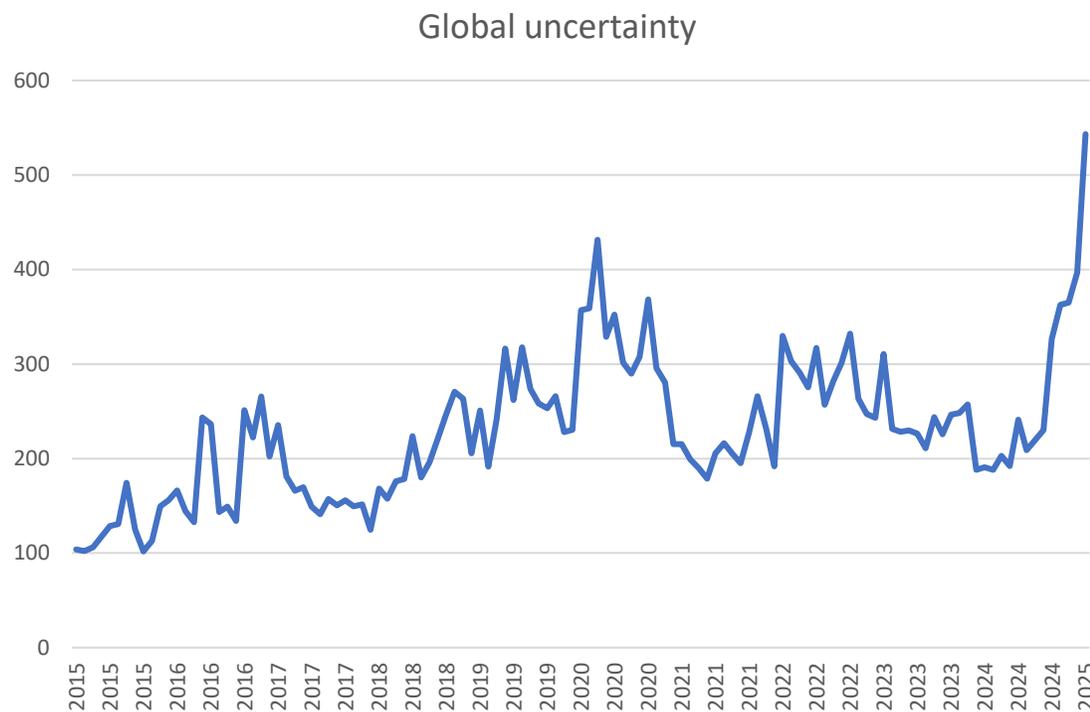
Outline:

Need to distinguish between Tectonic Shifts and short-term volatility

- Trump creates both short term volatility and could be a harbinger of a global shift. But impact on euro area economy likely to be limited.
- China encroaching on Europe's mid-tech sectors more important than Trumpian protectionism, but in the two can overlap for a time due to trade diversion.

Indicator of global economic policy uncertainty

Uncertainty this
really
unprecedented.
But in past some
mean reversion.
=> Steady hand for
monetary policy.



Global uncertainty: Being prepared for tail events

Serious disturbances in US financial markets cannot be ruled out, more because of fiscal policy than trade policy.

High impact, low probability event.

Difficult to predict how 'attack' on US dollar would play out.

—Flight into (relative) safety of euro assets? => Euro appreciates, but little danger for euro financial markets.

—Generalised selling of risky assets? => Some euro area sovereigns and weaker financial institutions under pressure.

Little monetary policy can do before it happens.

Being prepared:

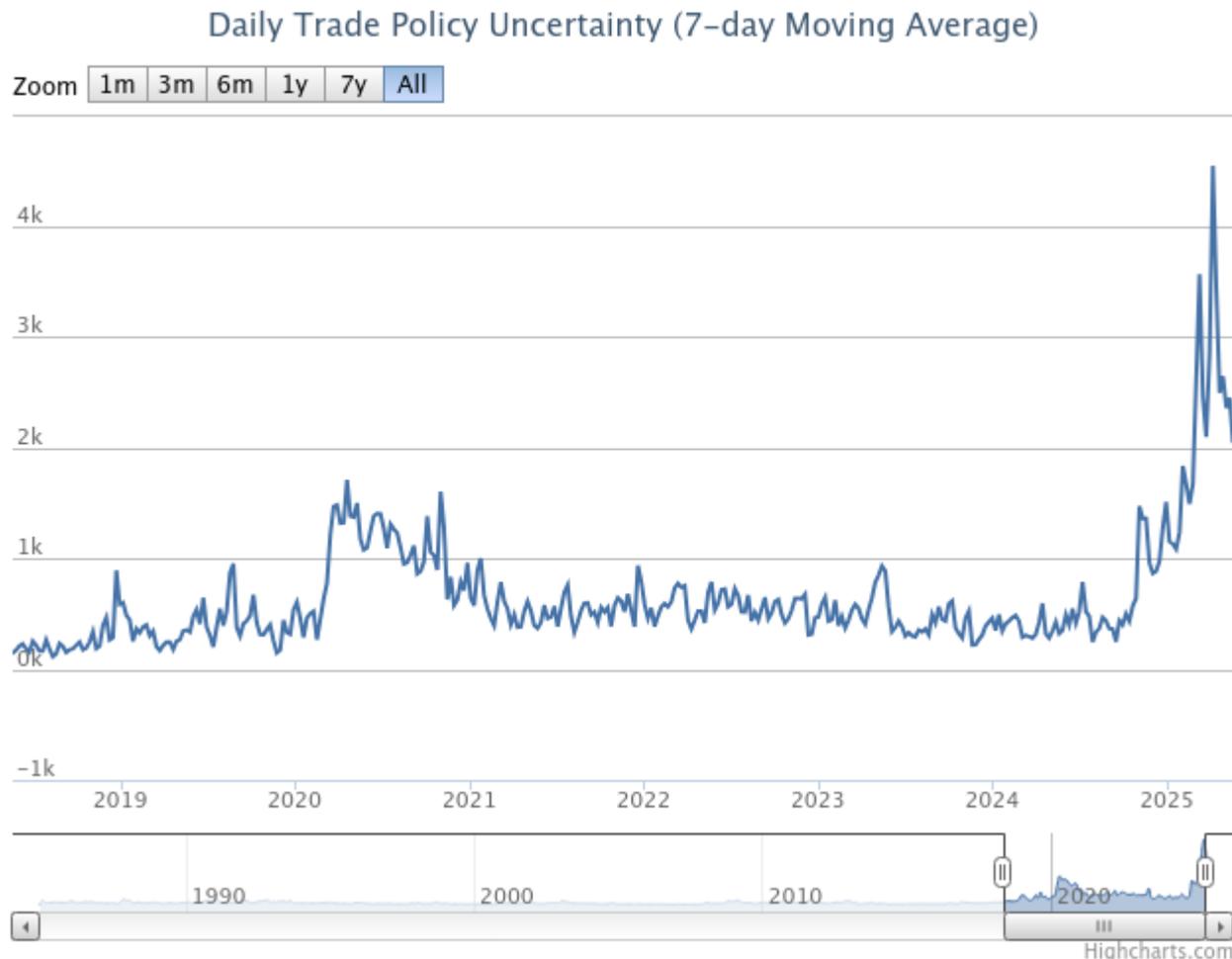
Keep tight supervision, debt levels under control.

Keep powder dry: ECB should sell assets while the sun still shines.

One key source of uncertainty: US protectionism

Trade policy uncertainty much more extreme than overall.

But here also some mean reversion (course correction by Trump already visible in high frequency data).



Impact of trade policy uncertainty on investment in Europe?

Increase in tariff rates still to be determined. This creates uncertainty for trade at unprecedented scale, Euro Area very open economy. Potentially large impact on investment.

Need to distinguish between i) a period of uncertainty that will be resolved in fixed time (90 days?) and, ii) permanently higher uncertainty.

- Transitory uncertainty: strong impact on investment (option value of waiting) – but temporary, followed by a recovery. Even a strong transitory (demand) shock no reason to react with monetary policy that aims at price stability in the medium term.
- Higher permanent uncertainty: impact on investment uncertain. If uncertainty is about prices (tariffs only) firms might invest more to be ready to catch opportunities (profit function is convex). But impact on euro area economy limited.

The impact of US protectionism on Europe, longer run effects

Basic hypothesis on (US) tariff rates:

30-40 % on China, 10-20 % on EU, (similar most of the rest of the world). Impact?

Most economists assume:

No change in current account deficit (US $S=17$ and $I=21$ % GDP). (More on I later.)

Same applies to EU, China and RoW.

⇒ Volume of trade goes down, but overall balances do not change ⇒ little demand effect.

⇒ Bilateral balances are likely to shift considerably driven by differences in tariff rates.

⇒ World welfare falls, but most of impact is on US (negative supply shock).

US accounts for about 15 % of global trade. If other countries do not erect trade barriers among themselves impact on global trade limited, a fortiori limited for EA.

The impact of US protectionism on Europe, opportunities from trade diversion

Differences in US tariff rates between EU and China creates opportunities (and political economy dangers of policy mistakes).

Likely constellation, say 40 % on China, 20 % on EU, can be viewed as a 40 % tariff for everybody, but 20 % subsidy for EU (and RoW).

Assume also China retaliates, with similar tariff rates on US (and no tariffs on EU or RoW).

=> RoW, including EU, benefits from this constellation.

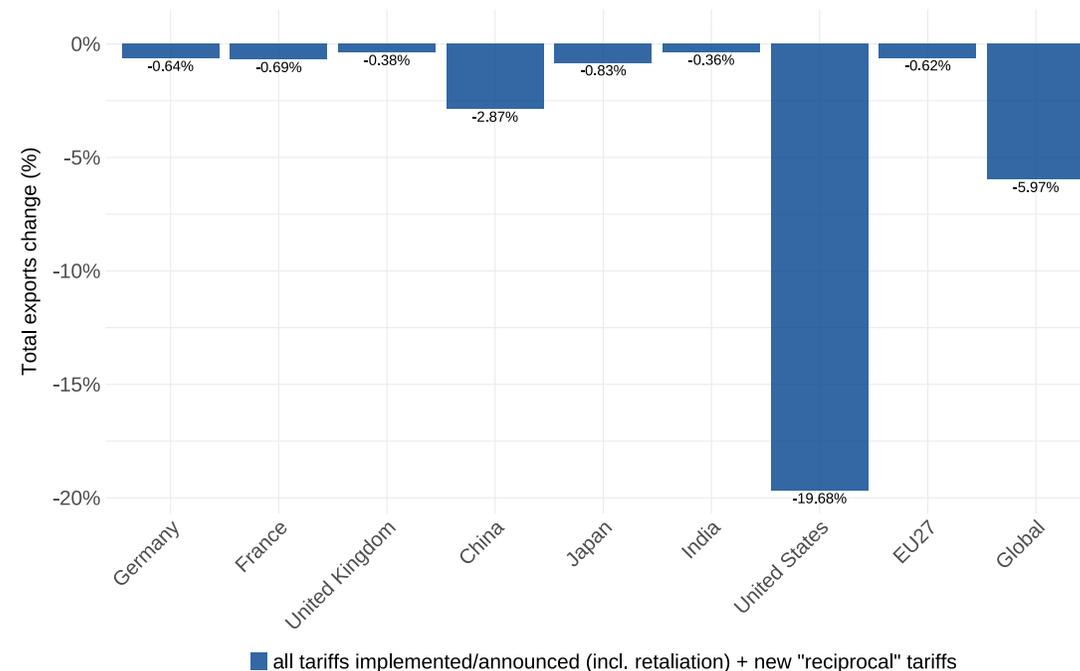
EU exporters no longer face Chinese competition on the US market (EVs, for example) and also less competition on the Chinese market (Airbus vs. Boeing).

Net impact of Trump tariffs on EU might be even positive (long run) but slightly negative in short run due to adjustment costs (simulations).

Implication for monetary policy: terms of trade gain: slight deflationary pressure on prices, but no loss of output.

Model-based estimates confirm view that competitive advantage of EU from US-China tariffs outweighs direct impact of 20 % rate on EU.

Short-run changes in total exports (in %)



Conclusion on trade wars

Europe has little to fear as long as US tariffs on China substantially higher than those on EU.

But adjustment will require flexibility as sectors subject to trade diversion from China not the same as those benefitting from more export opportunities.

Retaliation to US by others does not change big picture.

As long as others do not react to trade diversion by erecting trade barriers among themselves (EU-China key), damage to global trading system limited.

=> No big deflationary effect on euro area, despite high openness

EU reaction to China: Electric vehicles as example of global trade pattern under shadow of US China trade war

Conceptual mistake in concentrating on 'Surge' of imports of BEVs from China (*"EU cannot become outlet for Chinese production that no longer goes to US"*)

This thinking neglects the export opportunities to the US market protected from Chinese competition.

General theorem: If two countries impose tariffs on each other the rest of the world gains.

Real world illustration: EU has overall trade surplus in EVs. Any loss in domestic EU market share (so far limited) can be made up by higher exports to the US.

=>US-China trade war provides respite for EU manufacturing sector.

Evolving global trade pattern created by US decoupling from China:
in EVs, surge into EU and surge from EU to US?



The impact of US protectionism on Europe, danger of policy mistakes from trade diversion

Higher US tariffs on China lead to trade diversion ('flood of cheap Chinese goods').

How large could trade diversion be? Limited for EU:

Assume exports of China to US halve (minus 200 bn). EU takes about 20 % of Chinese exports => increase in imports from China about 40 bn euro, less than 10 %.

An increase of about 6 % of exports of EU to US (500 bn) and China (200 bn) would be sufficient to offset this, leaving the trade balance unchanged.

But increase in imports could be concentrated and visible whereas increase in exporters more diffuse and not visibly related to trade diversion.

⇒ Danger that EU makes mistake to increase trade barriers.

In this case monetary policy might have to deal with inflationary pressures (any tariffs would likely be on consumer goods)

Tectonic shifts

Key Tectonic Shift in global economy is emergence of China, whose implication for Europe is changing.

China encroaching on Europe's mid-tech sectors more important than Trumpian protectionism. It forces a realignment of large parts of industry.

Level and rate of change both matter.

Manufacturing current USD compared US, EU, CHN

https://data.worldbank.org/indicator/NV.IND.MANF.CD?end=2022&locations=CN-US-EU&name_desc=false&start=1997

China like a rocket,
but EU and US like
twins, Japan
disappearing in the
rear view.

Global total is 16
trillion =>

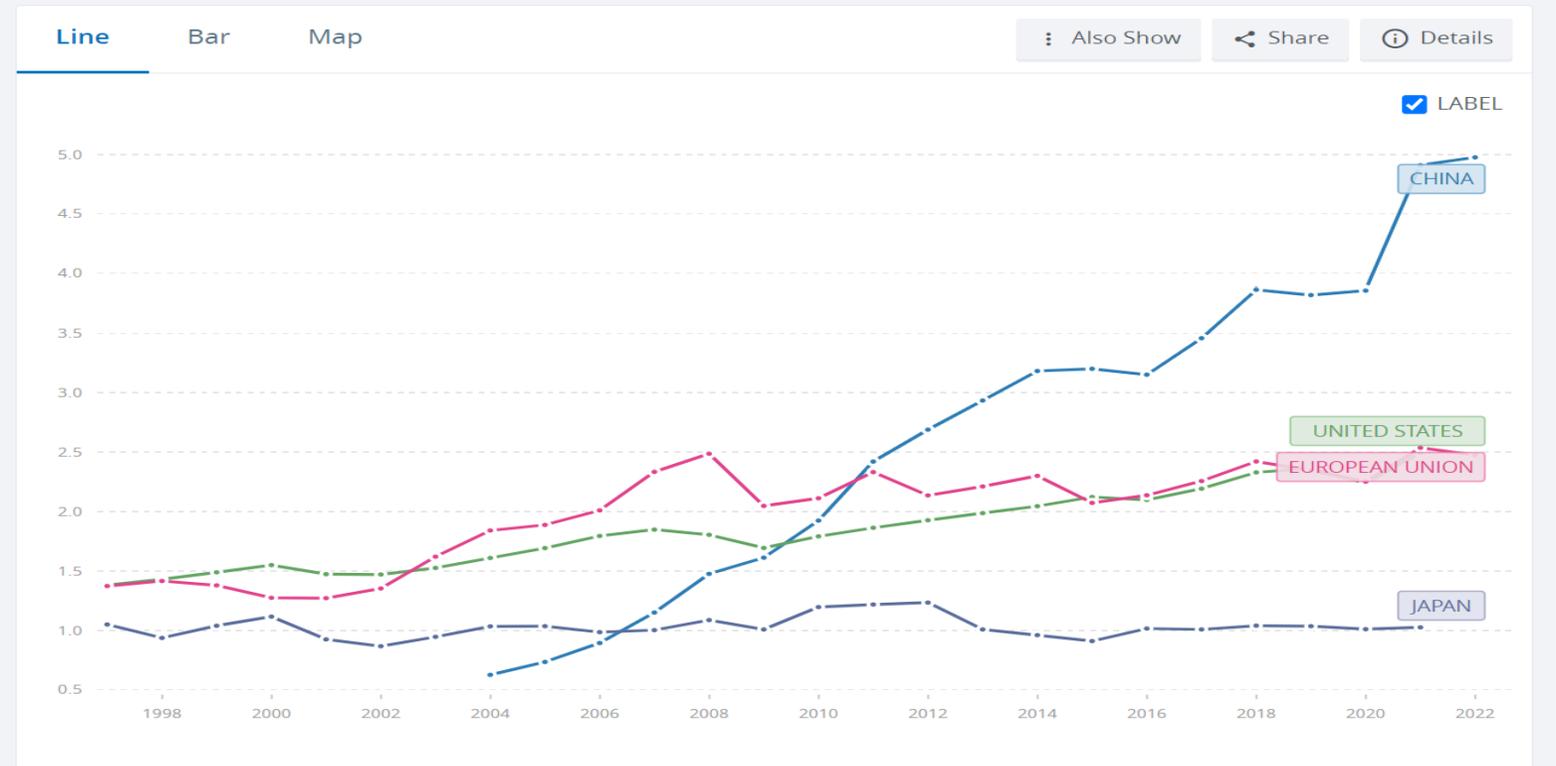
China = 30%, US and
EU 15 % each.

In 2000, EU+US = 50
% of world

Manufacturing, value added (current US\$) - China, United States, Japan, European Union

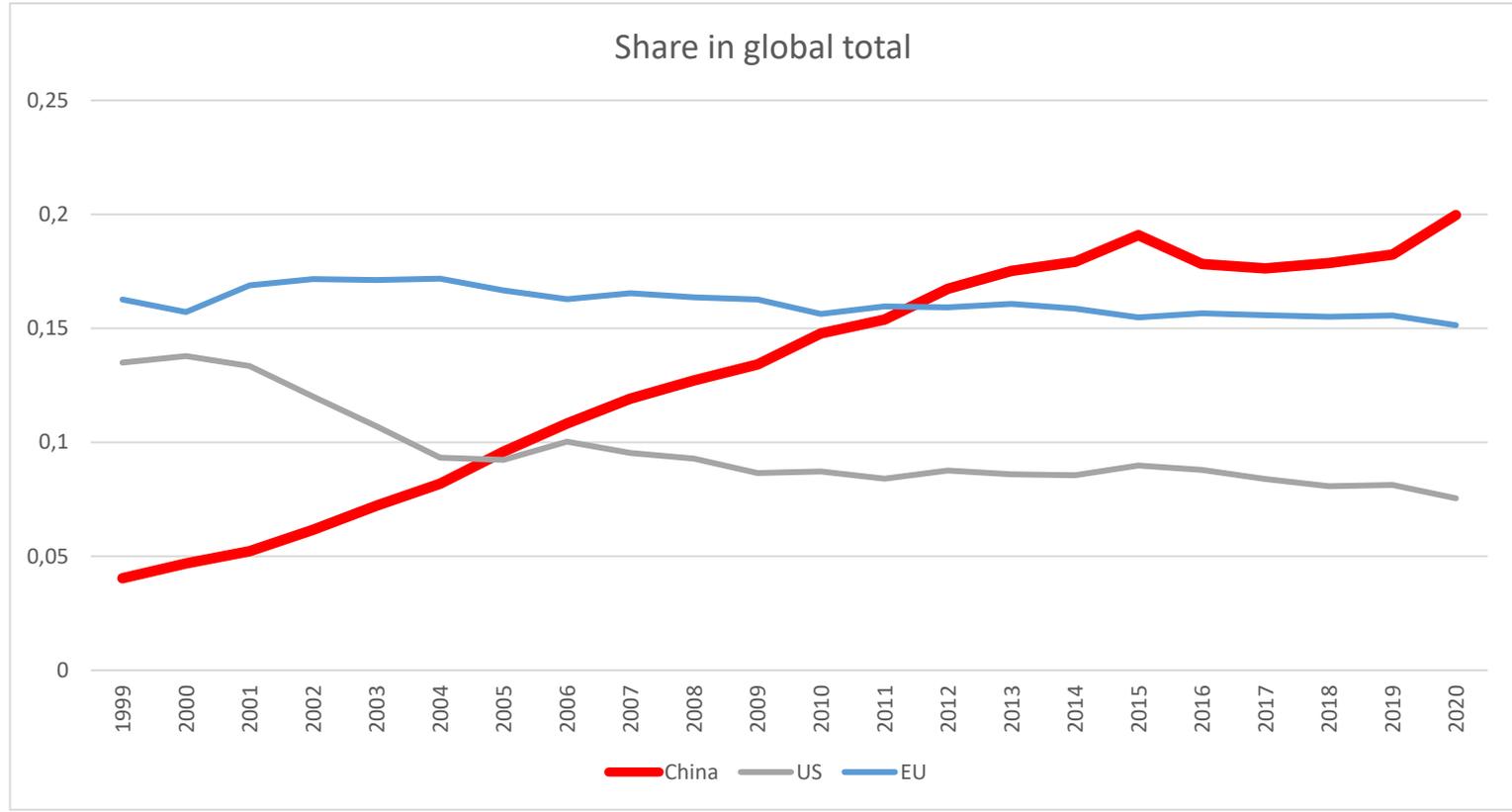
World Bank national accounts data, and OECD National Accounts data files.

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China's rise in global manufacturing exports, decline of US, EU (almost) stable

EU industry loses only little market share compared to US = EU competitive (one reason EU needs to pay for imports of raw materials).



Summary trilateral comparisons US/EU/China over last two decades

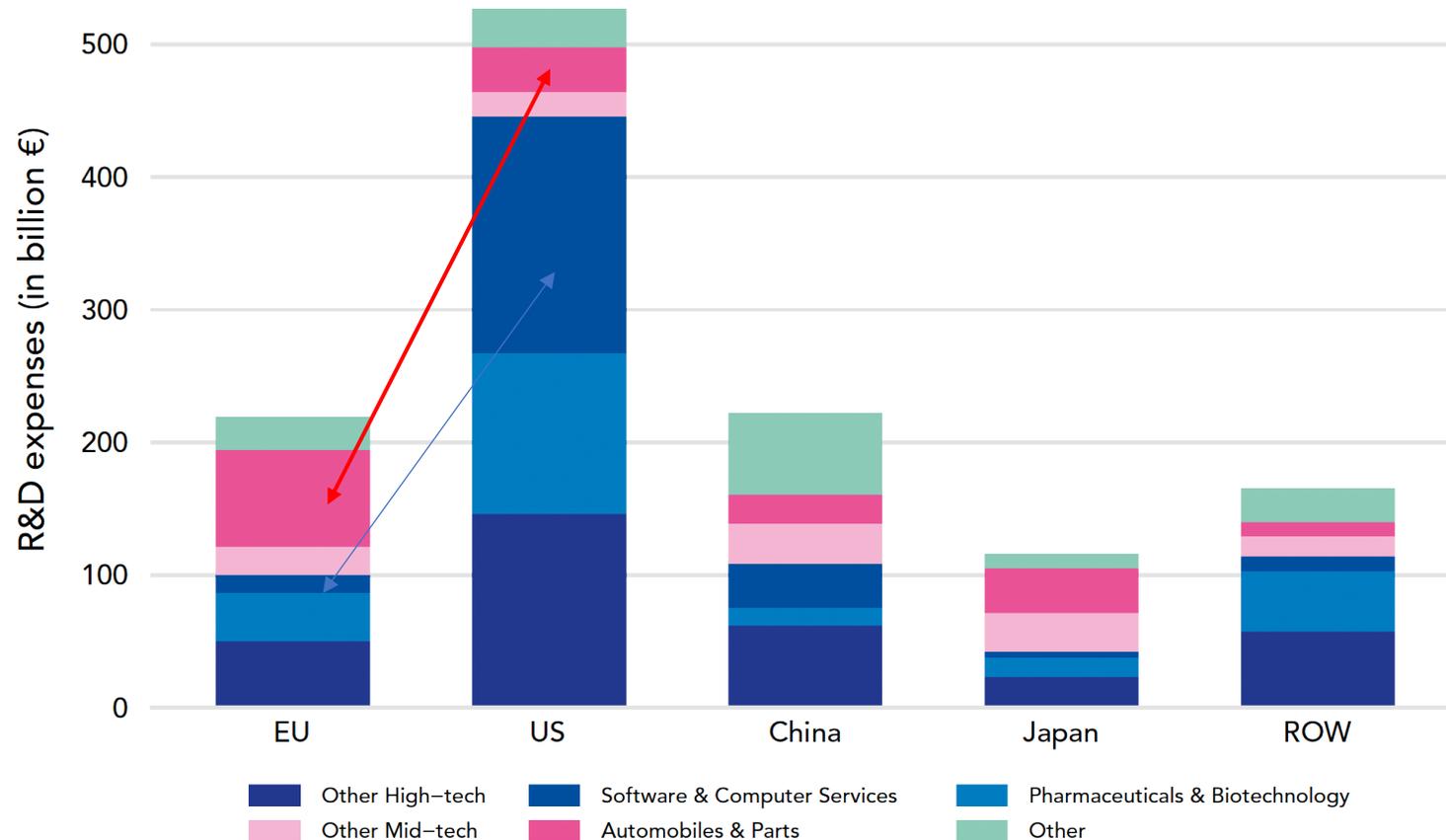
- Manufacturing: China's growth unprecedented: ten times (+1000 %) in less than 15 years. China's manufacturing output now equal to combined EU+US, unavoidable that China dominates many sectors.
- EU = US in manufacturing.
- => EU performance similar to US everywhere except ICT/software.

Innovation key to US success while the EU is stuck in a mid-tech trap

- Public support to innovation in the EU is comparable to US (similar 0.7 % GDP)
- The big difference is in private, business R&D spending (1.2% GDP in EU; in US it is 2.3%)
- Key overlooked element: composition is different.
- EU business R&D concentrates in mid-tech (e.g. automotive), rather than high-tech (e.g. software)
- Mid-tech industries grow less than high-tech
- Evidence of path dependency

The sectoral composition of Business R&D is key

BERD by Tech-level 2022 (Top 2,500 companies)



Total BERD US 3 times larger than EU.

EU > US in mid tech.
US >> in high tech

EU absent in software

EU specialization similar pattern as Japan and China.

China similar in absolute values to EU, but would be much higher in PPP terms (Chinese researchers much cheaper)

First conclusion

- Contest for supremacy in software (including AI) is lost. US software firms have outspent EU by hundreds of billions over decades => cumulated advantage is in thousands of billions.
- Transatlantic difference in Pharma, Aerospace somewhat smaller (less large) than in Software. Some catch-up might be possible here.
- N.b. Since composition of business R&D spending makes the difference the 3 % GDP target of R&D for EU impossible to reach in short run. Not even desirable for EU mid tech to spend much more on R&D (like Japan). Small EU high tech also prefers US.

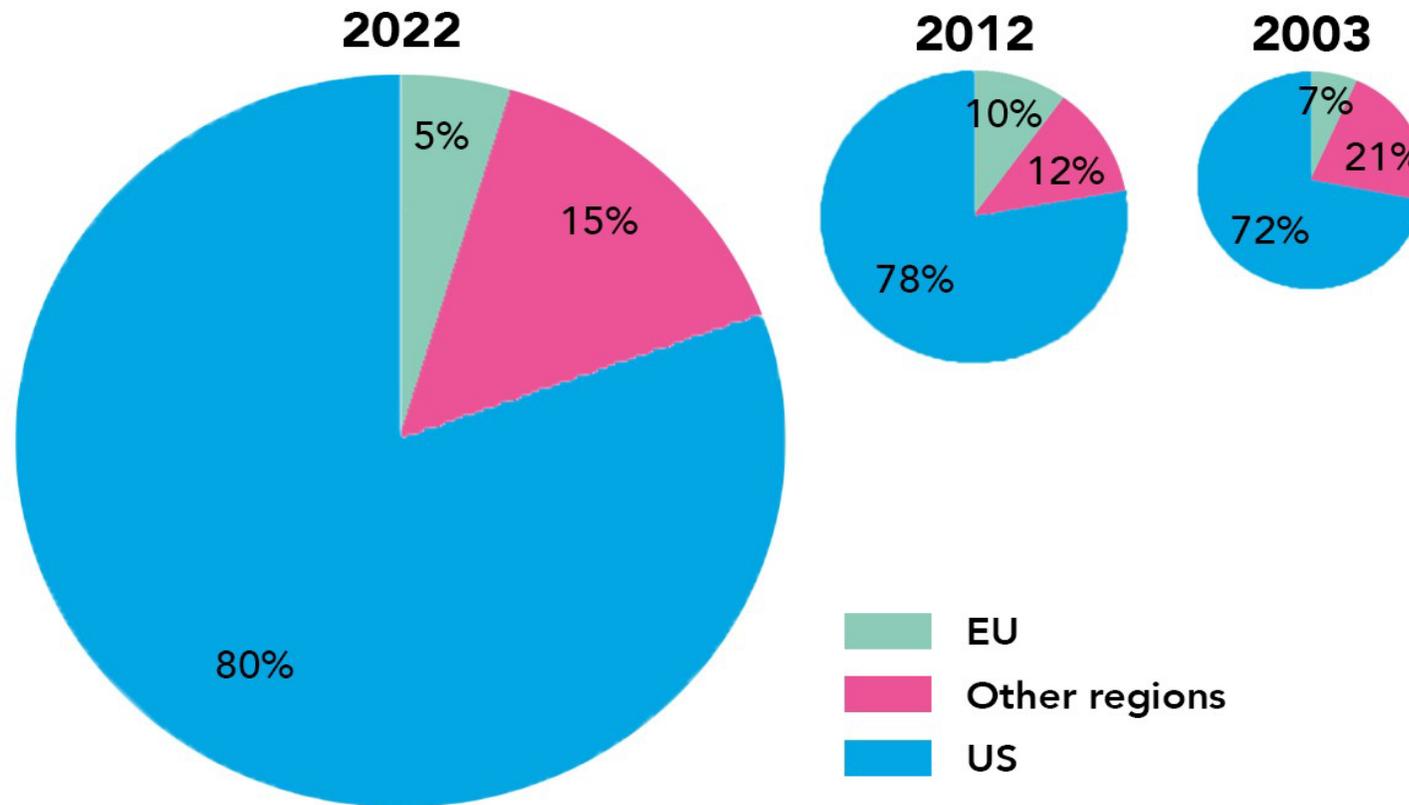
Top-3 R&D spenders and their industries compared over time

	2003	2012	2022
US			
	Ford 	Microsoft 	Alphabet 
	Pfizer 	Intel 	Meta 
	GM 	Merck 	Microsoft 
EU			
	Mercedes-Benz 	VW 	VW 
	Siemens 	Mercedes-Benz 	Mercedes-Benz 
	VW 	Bosch 	Bosch 

Source: Industrial R&D Investment Scoreboard (2004, 2013 and 2023).

Path dependency?

Country share of total interational BERD:
Software & Computer Sciences



US firms dominated the then small software sector already in 2003.

Dominance has increased even as sector has become 10 times bigger.

Pie size proportional to global total for software.

N.b. Distribution of revenues follow same pattern.

The Comparison with US is aspirational while new China threat creates real problems

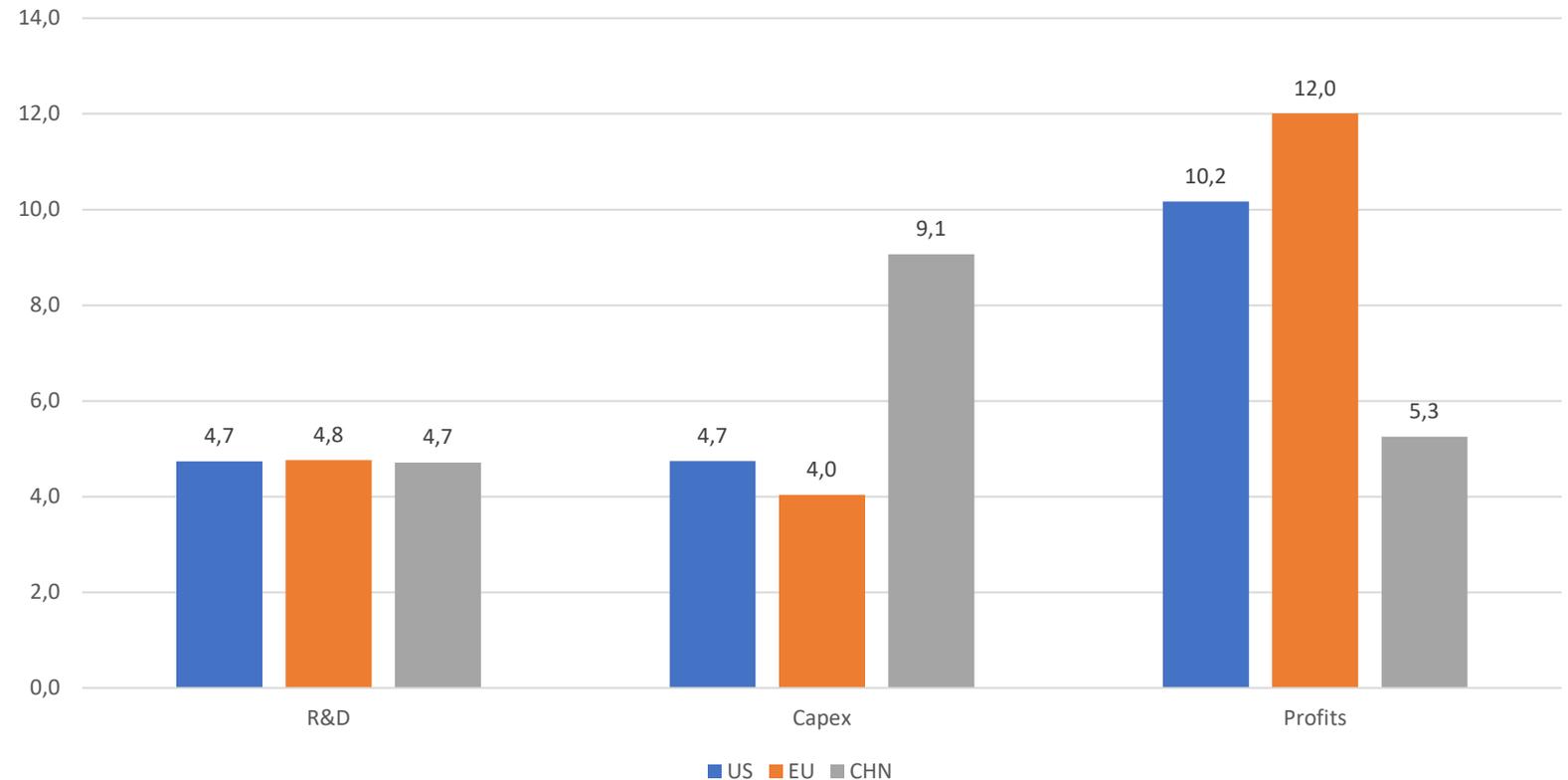
- In the past China used to dominate low wage industries.
- China (Chinese enterprises) now enter into mid-tech R&D.
- => In the future China will increasingly dominate mid-tech capital intensive sectors.
- Fears that China will dominate all industries baseless: trade is about comparative advantage.
- But some sectors will have difficulties (automotive).
- Best way to escape Chinese competition would be shift to high-tech.
- But this is Europe's Achilles heel and takes time.
- Monetary policy must be ready for long period of slow growth and continuous industrial adjustment.

EU China: Capital intensity makes the difference in mid-tech

Mid-tech:

China has caught up in R&D intensity, but invests more and accepts lower profitability (before subsidies)

Mid-tech: R&D, Capex and profitability compared



EU vs US: Dif and Dif:

Transatlantic difference in 10-year growth (23-13)
for 3 measures (bn euro)

HT:

US grows much quicker on all 3 measures, R&D plus Capex drive demand growth.

On MT the EU invests more (capex) and loses out much less in terms of sales

	R&D	Capex	Sales
High-tech	454	252	2193
Mid-tech	29	-24	473

EU China: Dif and Dif: Trans-Eurasian difference in 10-year (23-13) growth for 3 measures (bn euro)

HT: China outpaces
EU moderately on all
3 measures

MT:
China also advances
relative to the EU
especially in capex
and sales

	R&D	Capex	Sales
High-tech	67	50	820
Mid-tech	49	166	1215

Likely medium term background for Euro area monetary policy:

1. Sluggish growth, with some deflationary tendencies by increasing supply of cheap Chinese good.
2. Continuing need for industrial adjustment, but progress sluggish. R^* low.
3. Political pressure to cut rates to stimulate growth (and offset supposedly negative external effects).

Conclusions:

1. Confluence of Trump tariffs and Chinese upgrading creates impression of external threat, but real problem is internal.
2. Given the likely tariff differential with China, EU could well benefit from Trump tariffs.
3. Growth differential entirely from high-tech, especially software.
4. Both from profits and demand growth in investment (R&D and, more recently CAPEX).

Role of monetary policy mostly passive.