

Trade Tensions and Financial Stability

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Multilateral Trade Weakening

- Before we become concerned, we should try to understand causes
- First, some long run causes

Declining Trade Growth: Long Run Causes

- Not all barriers to trade are “artificial” impediments (protectionism)
- Some are “natural”
 1. Slowing Growth of Tradeables
 - Most trade is in goods (finished or not); productivity gains in secondary production have slowed over time (Gordon)
 2. Demand shifts from goods to services as income rises
 - Especially true as populations age
 - Many services are hard to trade
 - Most services hard to liberalize/harmonize/regulate
 - Hence proliferation of RTAs ... intrinsically hard to negotiate, getting tougher

Long Run Causes, continued

3. Stalled technological progress in transportation costs reduction
 - Few significant changes since containerization
 - Could be one real beneficiary of blockchain
 4. Country composition
 - Small countries trade more than the large; countries just aren't getting smaller anymore (they used to; dissolution of Soviet Union, Yugoslavia, Czechoslovakia, Sudan, ... Alesina)
- Hard to see any of these causes reversing themselves

Long Run Causes, concluded

Three Notes

1. A striking long run omission: declining “artificial” trade barriers
 - Protectionism trended down from 1945 on ... no more!
 - Not JUST Trump ... Doha never completed ...
2. Climate Change *could* also raise transport costs
3. Savings Glut from Germany, China, ...
 - Global imbalances mean global trade tensions
 - Populist backlash could lower trade per se (US)
 - Lowers real interest rates, hence nominal interest rates
 - Thereby makes central banks less able to respond to negative shocks, greater financial instability
 - Hence rethinking of monetary framework by central banks
 - Moving to fixed exchange rates becomes even less plausible ... a risk reducer

Short Run Causes of Trade Woes

1. Under-appreciated: absence of serious recent liberalization
 - Trade liberalization is like riding a bicycle (Bergsten)
2. Rise of US dollar (Gopinath)
 - US fiscal expansion; issuer of safe assets; European, Asian woes
 - When US \$ appreciates, trade tends to shrink
3. Explicit protectionism (duh!)
4. Policy-induced uncertainty, a consequence of protectionism: Trump
 - Exacerbated by lack of institutional support for rules-based nature system (WTO appellate judges)
 - Enduring since ... What does victory in trade war consist in? Objective? US trade balance (given savings and investment)?

This Uncertainty is Induced ... and Costly

1. Lowers physical investment (hence growth slowdown)
 - Much evidence (Bloom, Davis, ...)
 - This further lowers trade, since capital goods disproportionately traded; vicious cycle
2. Lowers firm investment in supply chains (make not buy)
 - General unraveling of efficient/complex international supply chains

Another Short Run Cause: Soft Power Erosion

- Part of trade decline because of loss of ‘soft power’
 - Hard power: ability to coerce via military and economic mass
 - Soft power: ability to co-opt via attraction
- Key political figures, regimes extraordinarily unpopular *abroad*
 - “Soft Power and Exports”: a country’s exports rise when its leadership is approved by other countries
 - Standard gravity model of bilateral exports (year x importer/exporter FE, controls)
 - Panel of data from 2006 through 2017
 - Annual Gallup survey: people in up to 157 countries asked about approval of job performance of leadership of China, Germany, Russia, UK, USA
 - Strong, robust result: ceteris paribus, country’s exports are higher if its leadership is approved by the importer

'Soft Power' Promotes Exports

- 1 pp increase in leadership approval raises exports by around 2/3% (statistically significant, robust) ... and Trump (2017) is >20pp less popular than Obama (2016)
- Key leaders (BoJo and the Donald) are *very* unpopular abroad
 - Symmetrically, loss/lack of soft power lowers exports

Summary: Causes of Trade Tension

- Long Run
 1. Slowing Growth of Tradeables, transition from Goods to Services
 2. Stalled Technological Progress in Transport Costs
 3. Stalled Liberalization, Savings Glut
- Short Run
 1. Protectionism
 2. Rise of US \$
 3. Policy-induced Uncertainty
 4. Loss of Soft Power
- All likely to be persistent

Effects of Trade Tensions on Financial Stability

Most Visible and Immediate Consequence of Trade Tension is *Macro*

- Slower growth ... because of uncertainty
 - Heightened possibility of macro downturn, recession
 - Hence more financial instability
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- But there are plenty of more insidious and indirect effects ...

More Persistent Costs of Trade Reduction

- Lower trade integration is costly in income, productivity, welfare
 - Mostly small now
 - Costs are mostly in long run supply-side because of foregone productivity and competition (also foregone consumer variety)
 - Likely to cumulate (consider quasi-autarkies: Cuba, North Korea, Venezuela)
 - Frankel-Romer, Alcalá-Ciccone, Hall-Jones estimates are big
 - ... though others (Rodrik, Subramanian and Trebbi) are not
 - Banal Second Moment Effect: less trade means less vulnerability to terms of trade shocks
 - Important for developing countries, commodity exporters
- Tangent: current protectionism is NOT counter-cyclic
 - US perpetrating during long boom with low unemployment and inflation
 - Unleashed protectionist pressures may be MUCH higher during next recession
 - Could lead to bigger future negative welfare consequences

Two Other Consequences of Slowing Trade

1. Business Cycle Synchronization
 2. Financial Stability
- Both Longer Run

Business Cycle Synchronization is Endogenous

- BCS is affected by trade (Frankel-Rose)
- Consider two economies hit by shocks which engage in trade
- Effect of exogenous decline in trade barrier on BCS? Ambiguous in theory
 - Negative: If most trade comparative advantage, then more specialization leads to lower BCS IF most shocks are idiosyncratic or productivity shocks
 - Positive: IF most trade intra industry OR most shocks are either common or preference
- Empirically, no ambiguity: more trade leads to higher BCS in practice
 - Use gravity determinants as instrumental variables
 - Quite robust: Baxter-Kouparitsas, meta-analysis

Trade explains part of BCS rise

- Trade has been rising (faster than income) for decades ... until recently ...
 - So no surprise that business cycles are becoming more synchronized
- By symmetry, lower trade leads to more idiosyncratic business cycles
 - In future, business cycle risk might be more national, hence diversifiable
 - Less pronounced global business cycle makes work of G20 and IMF easier
 - Likely increases financial stability

Reduced BCS affects Financial Stability

- Lower Trade and BCS means recessions – and hence financial stability issues – become *not only* more idiosyncratic diversifiable
 - But *also* fewer and more shallow recessions
 - Why?

Financial Integration follows Real Integration

- In theory and practice, real integration precedes, causes financial
 - Empirically overwhelming: liberalize goods markets before services; both before factor markets (capital and labor)
 - Far more countries have significant IMF AREAER restrictions on financial flows than goods
 - Deviations from LOOP big for goods; often immeasurably bigger for stocks/bonds
 - McKinnon's sequencing: international financial liberalization the final step
 - Financial integration a result of policy choices, typically following real integration
 - Ex: Europe 1992: capital and labor freedom *followed* trade liberalization
 - Generally, goods markets more liberal than services, both more liberal than financial flows
- So a world with less real (G&S) integration is likely to also be less financially integrated

Financial Integration Falls with Trade Tensions

- As with goods and services, less integration has its costs
 - Savings flow less efficiently to good investments
 - Risks can't be spread as widely across borders
- But considerable skepticism about size of benefits
 - Rodrik, Gourinchas and Jeanne , ...
- Different from trade integration

And ... Financial Integration Has Costs

- Quasi-Consensus on additional risks of financial integration
 - Contagion following currency crises in 1992, 1994, 1997, 1998, ...
 - (Relative) Immunity of the financially close in 2008-09 during GFC
 - International capital flows often “hot”; banking booms risky
 - More financially closed countries systems may suffer smaller crises compared with open economies, also experience less fewer financial crises
 - This compares open with closed, not rich and poor
 - Financial systems of developing countries – often closed – can be looted more effectively by domestic criminals (often their leaders)
 - Weaker institutions (including weak monitoring, including foreign) the cause

Financial Insulation not the Objective

- Still, protectionism *may* deliver inadvertent benefit at little cost
 - Cost of lower trade partially offset by lower contagion, fewer spillovers from foreign shocks

Conclusion

- Many effects of trade tension on financial stability ...
- And they're not all bad!

Effects of Trade Tension on Financial Stability

1. Short Run, Bad: higher likelihood of recession, raising financial instability
 2. Long Run, Bad and Good: less trade, lower income and welfare
 - But *may* enhance real and financial stability
 - Import fewer real shocks; financial repression bad for welfare but good for stability
 3. Long Run, Good: less globally coordinated business cycles
 - More easily diversifiable risk
 4. Long Run, Arguable: encourage rethinking of monetary framework
 - Exchange rates won't become more rigid, solidifying financial instability
 5. Long Run, Arguable: less financial integration
 - Fewer gains from integration (uncertain magnitudes)
 - Fewer risks from contagion
- More dramatic for OECD than developing countries/emerging markets