

Andreas Dombret: Current challenges for the European economy and international trade

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the German Chamber of Commerce, Beijing, 25 May 2017.

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1 Introduction

Ladies and gentlemen, probably all of you know that the Chinese name for Germany is “déguó”, meaning “land of virtue”. Therefore, we can safely say that trade relations between China and Germany were born under a lucky star. However, there are some clouds on the horizon casting a shadow on the future of international trade.

Without any doubt, this proposition needs further explanation. Thus, I will begin my statement today by briefing you on the economic situation in the euro area. Afterwards, I wish to present you the most important developments affecting the future of international trade – not only between Germany and China, but more generally the future of the international trading system as a whole. Namely, I will talk about the rise of protectionism in a number of large economies.

By the way, it is reassuring that China has so far pledged to maintain a stance that promotes free trade, as it did at the World Economic Forum in Davos, and is even looking for ways to expand it.

But I do not want to speak primarily about the policies of governments, but about what each of us – including central banks and international companies – can do to steer the debate on trade away from harmful protectionism.

2 Economic situation in the euro area

2.1 Positive economic outlook for the euro area

But first, let me look at the general economic outlook for the euro area and consider the factors influencing future economic growth in Europe. Since the financial crisis, the pace of recovery in the euro area has been slower than in the United States, not to mention fast-growing emerging economies like China. Lately, however, the economic recovery in the euro area has become increasingly broad and robust.

For the euro area, just in the last few weeks the economic development has been slightly on the upside. The concrete data as calculated by the ECB staff shows that for the euro area, we are looking at sound GDP growth of 0.5% for the first quarter of 2017. At the same time, inflation for April 2017 stood close to the ECB target at 1.9%. Unemployment in March was at 9.5%, down from its peak of 12% in 2013. On the whole, the euro area economy is looking increasingly healthy and is set on a growth path.

But looking to the future, we can see several factors dampening growth in Europe. Politically, the UK vote to leave the European Union has been a setback for the European project, but this decision is supposed to have a limited impact on the European economy as a whole, given the significant but limited weight of UK GDP. Even the Bank of England hinted in its most recent statement that the rate increase anticipated for 2019 might take place sooner than expected. Of course, the Bank of England stressed that this will depend on the outcome of the Brexit negotiations.

One persistent problem of the euro area economy is unemployment. I mentioned just now that euro area unemployment stood at 9.5%. However, if we look at the wider statistics published by the ECB on unemployment and underemployment, including discouraged workers or workers

who are not able to work as much as they want, we are rather looking at 18%. With the exception of Germany, where the combined figure is under 10%, most big euro area economies such as France, Italy, and Spain, still are facing the same problem of persistent and widespread unemployment and underemployment, especially among the young. The wider unemployment statistics have been falling slowly since early 2014 as well, but because people tend to lose their skills and their social capital when they are unemployed for a long time, helping these people retain or gain skills and getting them into jobs is vital for sustaining the recovery.

Because it is not yet clear when inflation will stabilise close to 2%, and because underlying inflation excluding energy remains below target, the ECB governing council has chosen to maintain, for the time being, its accommodative monetary policy stance with negative rates and extensive asset purchase programmes. However, at the April press conference, ECB president Draghi conceded that “the growth risks were moving towards a more balanced configuration.”

In sum, despite Brexit and the persistence of unemployment in many European countries, the short-term outlook for the European economy is cautiously optimistic. Fundamental weaknesses such as persistent unemployment need to be addressed by governments with structural reforms. Until these underlying problems are resolved, political risks will remain the biggest threat to European economies over the medium to long term.

The danger exists that populist parties could make European countries unable to respond effectively to crises and changes. I will discuss the underlying causes of this political risk later on: Dissatisfaction with free trade and flirting with protectionism.

3 Future of international trade

Looking at the global landscape, positive economic data are not only coming from Europe. For the first time since a brief surge in growth in 2010 we are experiencing a synchronised recovery that is taking place broadly across Europe, the United States, as well as in China and emerging market economies. This synchronised recovery will support international trade and vice versa. At the same time, we have witnessed public attacks on international trade and the system that supports it, which is based on the free flow of goods and capital.

Protectionist sentiment in developed economies is rising. Promises to cut back on free trade have resounded with voters in some developed countries. While it is still unclear what – if any – protectionist policies will actually be implemented and how they will affect international trade, it is clear that leaders in government and business have not been able to persuasively defend the virtues of free trade, and that the future of international trade will depend precisely on their ability to do just that.

Let me brief you about this discussion and the action that has to be taken. We have to adopt a stance that is both correct and compassionate. That is: Restrictions on international trade will do much more harm than good and would be a historic mistake. And we must be compassionate: Even though the reasoning of those who call for protectionism is ultimately wrong, we have to recognise that there are parts of society who believe international trade is responsible for taking away their jobs.

3.1 Is free trade useful?

For a long time, the usefulness of international trade has been undisputed, and international policymakers have concentrated on ever-more detailed arrangements and standards. That is no longer the case anymore: The core of the international trade system is being questioned. Protectionism is back, and even mercantilism, dead for centuries, has reared its ugly head again. In this context, I am convinced that this trend is leading us down the wrong path. The social and economic issues that countries across Europe and around the world are facing are not at odds with the conventional wisdom regarding international trade, and they cannot be solved by falling

back into protectionism.

What globalisation statistics show is that economic integration does indeed raise aggregate wealth. Worldwide exports and imports have reached roughly 60% of global GDP¹, and there has been a surge in global economic integration in recent decades. At the same time, real income has been growing globally and across the income spectrum since the 1980s.²

These developments are not accidental side effects. Indeed, trade theory predicts a more efficient allocation. This happens for a variety of reasons, such as comparative advantage or economies of scale. Economic integration also facilitates the transfer of knowledge, bringing innovation to places that would otherwise not have benefited from new technologies.

At the same time, just because trade leads to gains overall does not mean no one will be left worse off. This has been studied since the early days of international economics. Recent surveys have identified groups that have suffered from international trading arrangements, at least relative to their national peers.³ Think about communities in the American Midwest or Northern France: both are regions where manufacturing jobs have disappeared with devastating effects on the social fabric of their communities. Some shifting of manufacturing jobs is not proof that international trade theories have failed – indeed it is part of the evidence that the theories are right. Accepting trade theories thus means accepting that there may – and most probably will – be negative consequences for some communities.

3.2 Mill's solution

The answer to this political-economic problem was given a long time ago by John Stuart Mill and can be put simply as “free trade plus compensation”⁴. Compensation can take many forms. The member states of the euro area tend to provide extensive social benefits. At the same time, the euro area countries trade freely with each other and we conclude from this that free trade and compensation are not mutually exclusive.

Let me be clear that assistance in the form of benefits is not the only and certainly not the most effective way to help people. First, I am also talking about measures to retrain workers: Such active labour measures are found to significantly reduce unemployment and long-term unemployment in OECD countries⁵. Second, we should value the positive effects of international standards. They help to maintain a level playing field and to prevent a regulatory race to the bottom in policy fields that serve the whole of society. Think about international labour standards as an example.

However, not all countries are implementing these measures. Why is that? The populists' solution to the problem is “cut down on free trade, it's hurting jobs!” The problem with this solution is that it is deeply misleading. First, there is more than one reason for the loss of manufacturing jobs. Advances in efficiency due to technology and automation have permanently reduced the number of workers needed to manufacture a given output. The managing director of the IMF Christine Lagarde highlighted in a recent speech that “technology has been the major factor behind the relative decline of lower- and middle-skilled workers' incomes in recent years, with trade contributing to a much lesser extent.”⁶ Erecting trade barriers will do nothing to recover jobs lost as a result of automation. While it is true that some manufacturing jobs have moved to emerging countries, all theory and evidence shows that international trade has been a net gain for Europe, the United States, as well as for the rest of the world. We have to confront all those who distort the facts about the supposed benefits of protectionism, because following their advice would be a disaster for world trade and would not help those who feel left behind. The opposite would be the case, since protectionism would reduce the size of the total economic pie, leaving society worse off on the whole.

At the same time, we must not fall into the trap of self-complacency. The “Washington

consensus” has dominated the discourse on international economics from the 1990s until the early 21st century⁷. Its proponents have welcomed the advance of free trade in the name of economic efficiency. While their argument is technically sound, they have not provided any answers for those who have seen their share of the pie stay the same size or even get smaller.

We have to admit that, as part of this consensus, policies were recommended that generally reject any form of “free trade plus compensation”. To be fair, such a balanced approach has not been rejected because of any lack of compassion, but because it was believed that a minimum of regulation would be beneficial for trade and economic development. Indeed, almost 20 years ago Harvard economist Dani Rodrik, one of the most distinguished scholars in the field of international economics and political economy, accurately noted that “governments today actively compete with each other by pursuing policies that they believe will earn them market confidence and attract trade and capital inflows: tight money, small government, low taxes, flexible labor legislation, deregulation, privatization, and openness all around.”⁸

I think his observation explains why not enough attention was given to Mill’s advice about “free trade plus compensation”. We are at risk of a backlash against international trade because leaders in some countries have not been able to give convincing answers to those who have seen their standard of living decline, either due to free trade or due to technology. In this sense, leaders in institutions, government, and business should not discount or oppose sensible measures in the field of regulations or social security, because these measures help defend the consensus that free trade is beneficial for us all.

3.3 Outlook for future Free Trade Agreements

At this point, and after so much gloom, it is time to not only talk about the threats to international trade but to share a few ideas about the opportunities opening up for trade.

One development that is sure to gain in importance in the coming years and decades is trade not only in goods, but in services. Historically, we have focused on trade in what are known as tradable, manufactured goods. But technology is continually expanding the range of tradable services. Think about internet e-commerce platforms that can provide their distribution service from anywhere in the world, think about a professional consultant, a programmer or even a medical doctor, professionals who use modern technological tools of collaboration and communication and who can provide their services from anywhere in the world.

In fact, we could very easily be holding our meeting today by video conference, although I myself very much prefer making and maintaining contacts on a personal basis. There will surely always be a need for personal dialogue.

The planned Trans-Pacific Partnership contained provisions that addressed the blurring between tradable goods and supposedly non-tradable services. Even though the future of the treaty is currently uncertain, finding an international trade framework for digital goods and services will continue to be highly relevant.

There are more examples of developments favourable to international trade. One such example is the Trade Facilitation Agreement, which entered into force on 22 February 2017 after it was ratified by two-thirds of the World Trade Organization’s members.⁹ Another example is the CETA treaty between the European Union and Canada that is in the process of being ratified and adopted.¹⁰ The “one belt, one road” initiative was promoted with much publicity at a summit in Beijing just ten days ago.¹¹ While it remains to be seen whether the proposed project will meet European standards of fairness and transparency, it clearly shows that enthusiasm for international trade is far from dead.

4 Conclusion

Ladies and gentlemen, I have argued that even if international trade is far from dead, we can no longer take it for granted that the conditions and moods favouring international trade will prevail in the future.

In Europe and in other developed countries, there is an open discussion on the merits and drawbacks of international trade. We have to join in this discussion if we are to preserve and expand international trade. We will have to think long and hard about how to implement the principle of “free trade plus compensation”, that is how to help those who are losing out to adapt to the changes brought about by international trade and technological progress.

In this way, citizens in Europe, in China, and all over the world will recognise that international trade is a virtue in our societies, not a threat.

Thank you for your attention.

¹ Source: Penn World Tables Version 8.1.

² Source: Milanovic, B. (2013). Global income inequality in numbers: In history and now. *Global policy*. 4(2): 198–208.

³ On domestic distributional consequences of international trade, see, for example, Acemoglu et al. (2016). Import competition and the great US employment sag of the 2000s. *Journal of Labor Economics* 34(S1): 141–198; McKinsey (2016). Poorer than their parents? A new perspective on income inequality. Available online: www.mckinsey.com/global-themes/employment-and-growth/poorer-than-their-parents-a-new-perspective-on-income-inequality.

⁴ John Stuart Mill argued in 1825 for the possibility of winners compensating losers in the context of the repeal of the Corn Laws. See: *The Collected Works of John Stuart Mill, Volume IV – Essays on Economics and Society Part I*, ed. John M. Robson, University of Toronto Press, 1967. Available online: oll.libertyfund.org/titles/244#Mill_0223-04_311.

⁵ On the effectiveness of active labour measures: ftp.iza.org/pp84.pdf, p.10.

⁶ Speech of Christine Lagarde at Bruegel think tank, April 12, 2017. Available online: www.imf.org/en/news/articles/2017/04/07/building-a-more-resilient-and-inclusive-global-economy-a-speech-by-christine-lagarde. On this issue see also the findings of the IMF in the *World Economic Outlook April 2017*, Chapter 3, p. 122f. Available online: www.imf.org/en/Publications/WEO/Issues/2017/04/04/world-economic-outlook-april-2017.

⁷ A summary on the debate is given by Joseph Stiglitz in “The Post Washington Consensus Consensus”. *The Initiative for Policy Dialogue*, 2008. Available online: policydialogue.org/files/events/Stiglitz_Post_Washington_Consensus_Paper.pdf.

⁸ Dani Rodrik (2000). How far will economic integration go? *Journal of Economic Perspectives*, 14(1).

⁹ Source: www.wto.org/english/tratop_e/tradfa_e/tradfa_e.htm.

¹⁰ Source: ec.europa.eu/trade/policy/in-focus/ceta.

¹¹ Source: www.xinhuanet.com/english/special/201705ydyforum.