PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Systemic Risks for Europe From The New Economic Geography

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"No longer will our generation enjoy the peace dividends. It is up to us to ensure that one day, our children will enjoy the dividends of our efforts."
– E. Macron, 05 March 2025

The Peace Dividend should be conceived of as more than just spared defense spending

The Peace Dividend took the form of enabling us to forget about security risks for large parts of portfolio allocation, to take international financial arrangements for granted, and to assume a restrained state role.

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Economics | Davos 2024

Posen Warns Peace Dividend Is Reversing as Global Tensions Rise

5 March 2025 - Check against delivery   Download pdf

Address to the French people by M. Emmanuel Macron, President of the Republic.

Men and women of France, my fellow citizens,

I am speaking to you this evening because of the international situation and its consequences for France and Europe, following several weeks of diplomatic activity.

You are rightfully concerned by the historic events under way that are disrupting the world order.

The war in Ukraine, which has killed or injured nearly a million people, is continuing at the same level of intensity.

The United States of America, our ally, has changed its position on this war, lessening its support for Ukraine and raising doubts about what is to come. At the same time, the United States intends to impose tariffs on products from Europe.

Meanwhile, the world continues to be ever more violent, and the terrorist threat has not lessened.

All in all, our prosperity and our security have become increasingly uncertain. Clearly, we are entering a new era.

The New Economic Geography

The regime shift in essence

1. You had a beach house with good insurance, but now…
2. Ideally, you could pay more for more coverage/higher risk
3. Instead, you are having to pay a lot to insure against insurer
4. While the risks are going up, and your income is going down
5. Self-insurance is necessary and leads to relocation and reallocation of investment

US reduces insurance provided and safety of $ assets

The New Economic Geography FOREIGN AFFAIRS NEWSLETTERS ACCOUNT

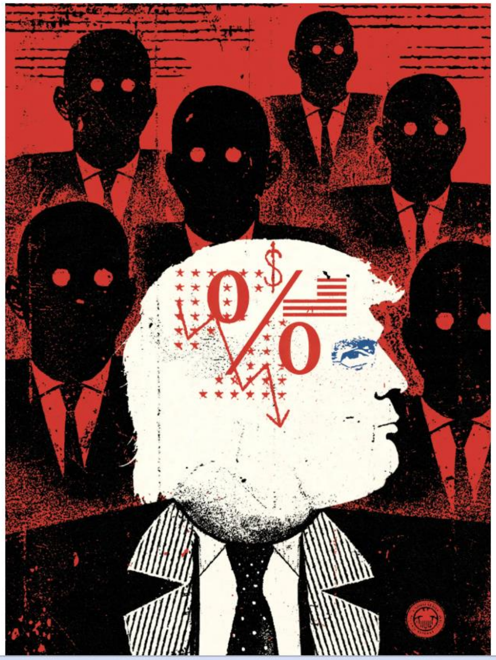
The New Economic Geography

Who Profits in a Post–American World?

ADAM S. POSEN

September/October 2025

Published on August 19, 2025



1. Fundamental persistent change in regime/offering
2. The more integrated or dependent with US, the worse off from change
3. Extraction will be repeatedly renegotiated
4. Changes in security and economic ties will reinforce each other
5. Shortage of safe assets, not because of low issuance, but eroding quality of existing ones

Economic themes describing the new geography

1. The change in US policy and practice is fundamental and lasting
    1. Ongoing raised uncertainty level as in Brexit
    2. USG deliberately imposed tactical uncertainty creates irony of alliances
2. This change will have major impacts on US and global economy
    1. Increased supply shock incidence, fiscal deficits, UST long interest rates
    2. Disrupted business networks, FDI and migration flows
    3. Depressed growth and credit for the rest of world outside of G20 EM
    4. Decreased US dollar centrality (initially a step-change down)
3. Expect financial repression, diversion of capital flows, bubbles
4. Both China and the EU have opportunities, but nothing assured

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US commercial relations will stay where we are

Once legislated, tariffs are almost never reversed

"Strategic" sectors will have few exemptions

Demands for FDI, arms and energy purchases

25% tariff on Canada and Mexico sets up USMCA issues

Across the board 10-15% tariffs for revenues

Contradictory moves on USD/fiscal

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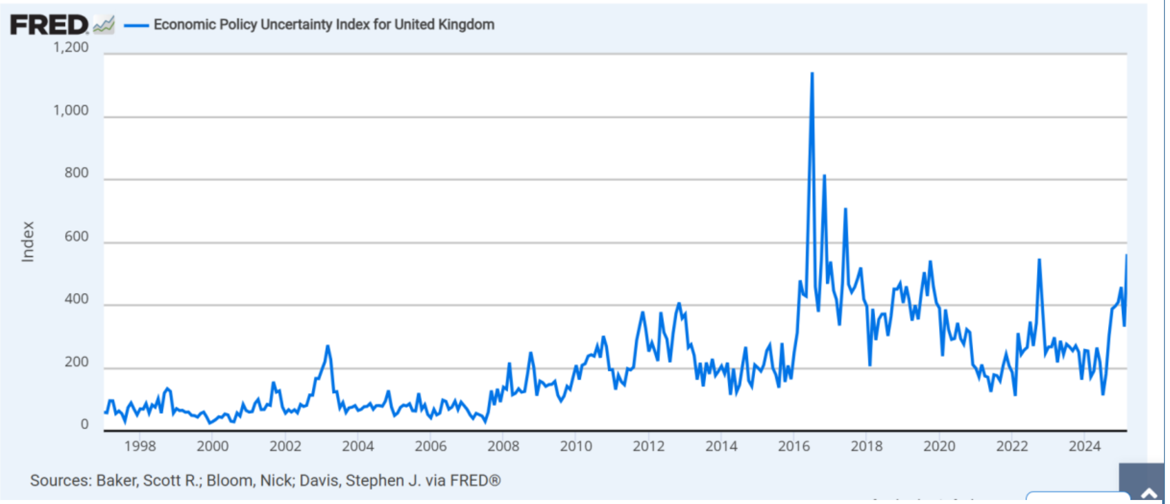
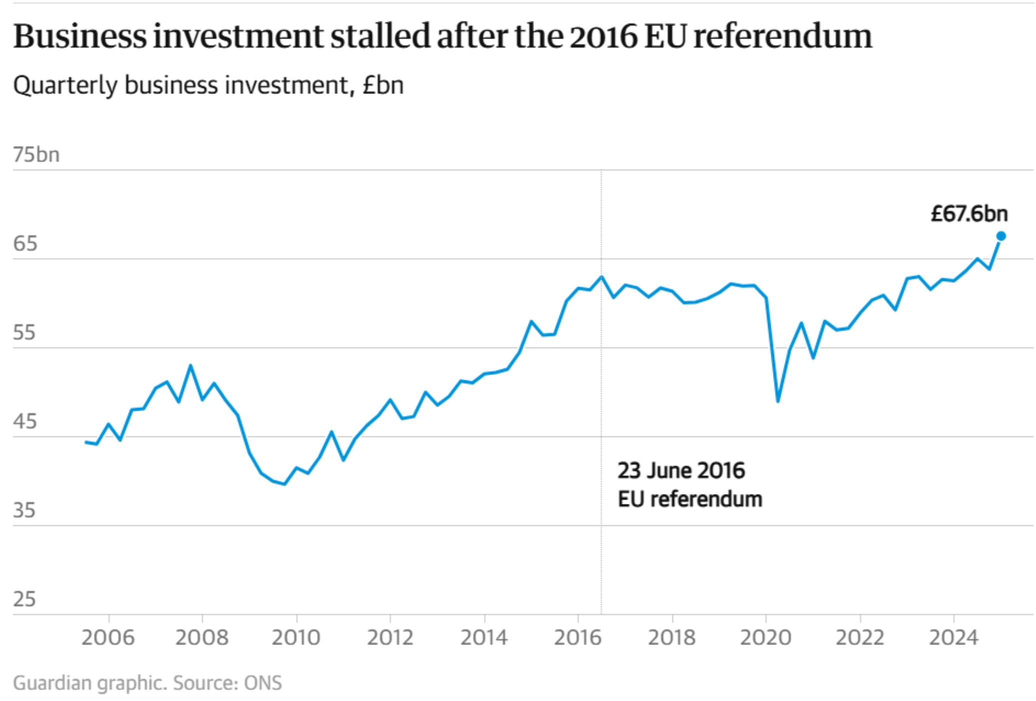
The problem with trade war isn't uncertainty about the war, the problem is the war itself

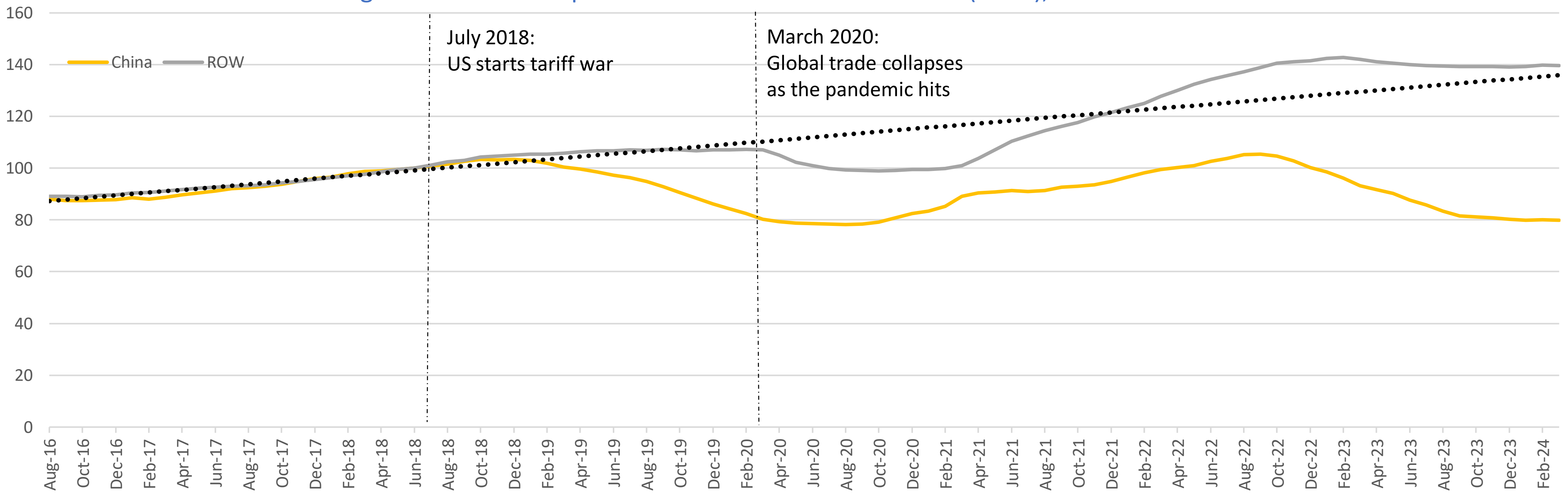
- This isn't transitional - it is a regime of higher uncertainty
  - *(a la Brexit)*





After Trump 1.0, US reduced Chinese imports

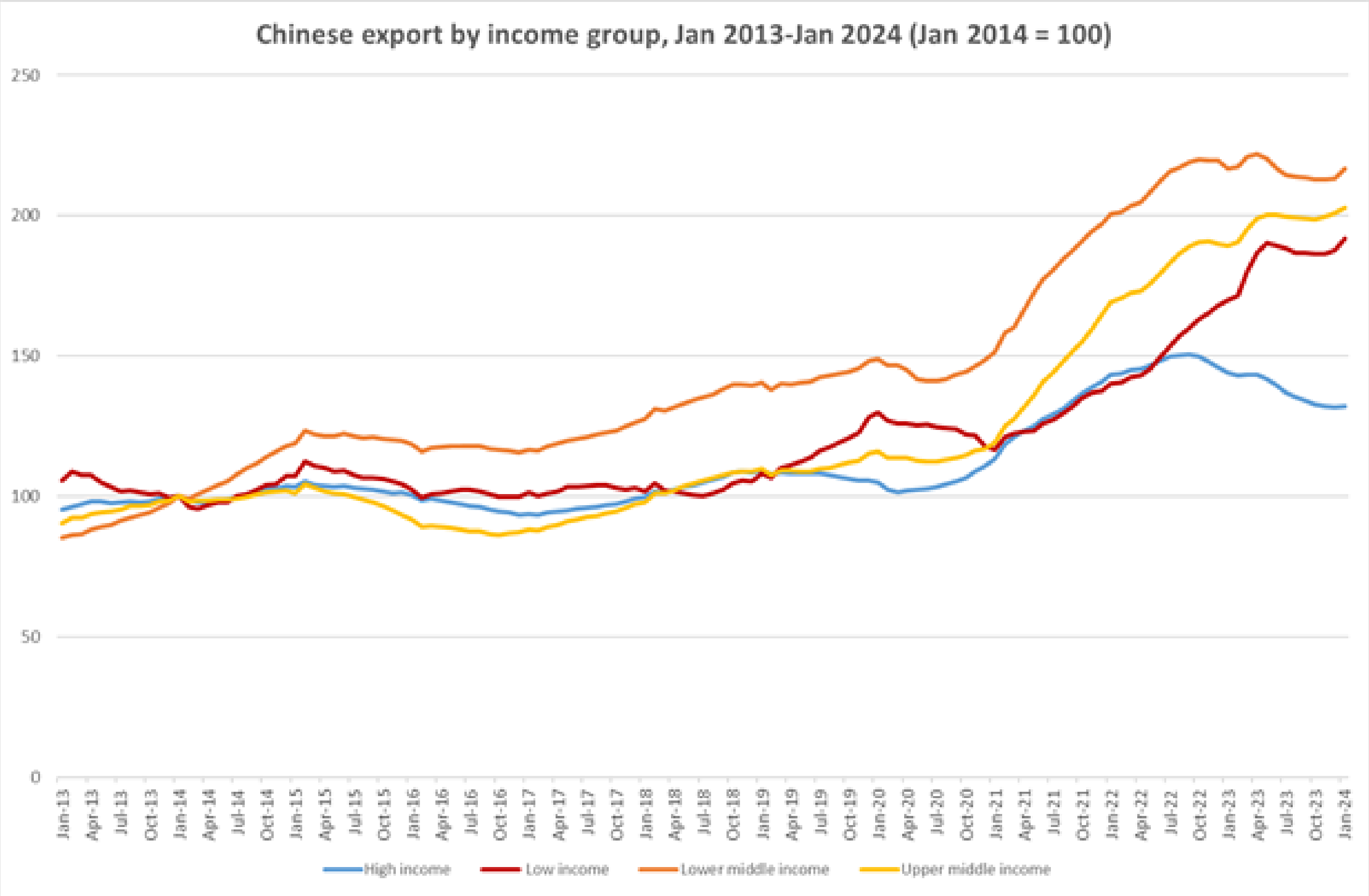
Figure 3. Total US imports from China and rest of world (ROW), June 2018 = 100



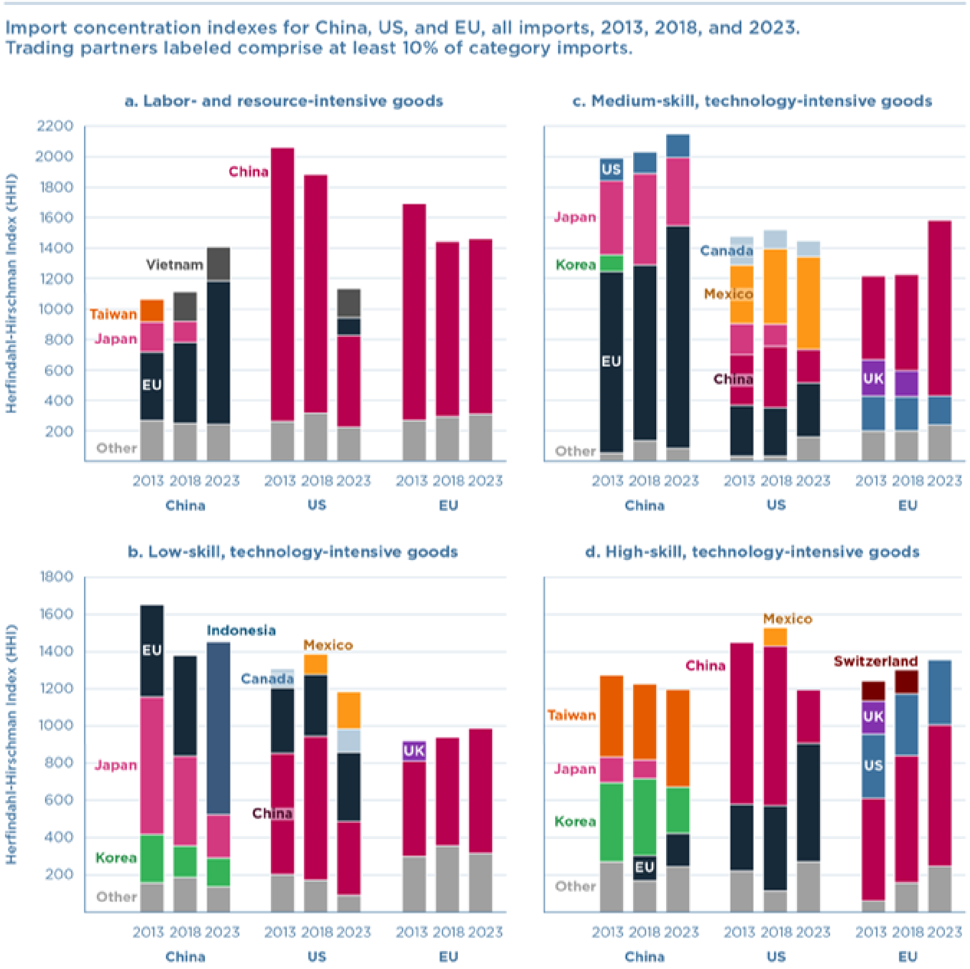
Note: The dotted trendline is the line of best fit based on US imports from the world from August 2016 to June 2018.

Source: Constructed by the author with US import data from US Bureau of the Census, updating an original graph in Bown (2022b).

After Trump 1.0, China shifted to new markets



EU increased its reliance on Chinese tech



Note: Concentration is measured by the Herfindahl-Hirschman Index (HHI). Degrees of manufacturing are defined by UNCTAD. For consistency, references to the EU pertain exclusively to the EU27, excluding the United Kingdom throughout the analysis period. Sources contributing less than 10 percent to the annual import share are grouped under "Other."

Source: Constructed by the authors with US import data from the United States International Trade Commission's DataWeb, EU import data from Eurostat, China import data from China Customs (2023) and UN Comtrade (2013 and 2018).

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Foreign policy implications for the role of the US dollar

There are (were) two open secret components to US dollar dominance

1. The lack of viable alternative (“Least Ugly Contest”)
2. The security regime which was tied to the US

Limited deviations around either aspect had self-correcting forces

- Even when US caused problems, money flowed into the US for relative safety

Changing the underlying regimes – domestic and international – **reverses the sign of the capital flows** when the US is the cause of problem

- Recent Treasury/dollar co-movements are necessary but not sufficient indicator

Alliance and security ties previously supported the dollar

- Dollar reliance far outstrips economic/financial explanations
- Reserves and de facto exchange rate pegs responded little to variations in economic factors
- Network effects is a way of labeling a residual, not a cause
- Missing mass is security ties

International Finance

Free Access

Why the Euro will Not Rival the Dollar*

Adam S. Posen

First published: 27 May 2008 | https://doi.org/10.1111/j.1468-2362.2008.00217.x

“[C]ausality runs as much from security leadership to economic leadership as in the other direction, meaning that some apparently disparate aspects of US global hegemony will tend to rise or fall together...",

“Decisions to link to the dollar (and to accumulate dollar reserves for intervention) from Taiwan to Saudi Arabia to Panama depend as much on foreign policy as economics.”

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Eichengreen, Mehl, and Chitu (2019), "Mars or Mercury? The Geopolitics of International Currency Choice"

When added to the intellectual portfolio of economists, this second hypothesis helps to explain some otherwise perplexing aspects of the currency composition of international reserves. It helps to explain why Japan holds a larger share of its foreign reserves in dollars than China. It helps to explain why Saudi Arabia holds the bulk of its reserves in dollars, unlike another oil exporter, Russia. It helps to explain why Germany holds virtually all of its official reserves in dollars, unlike France. Germany, Japan, and Saudi Arabia all depend on the US for security. China, Russia, and France, on the other hand, possess their own nuclear weapons as deterrents. Comparing nuclear weapon states and states dependent on the US for their security, as in Figure 1, suggests that the difference in the share of the US dollar in foreign reserve holdings is on the order of 35 percentage points.

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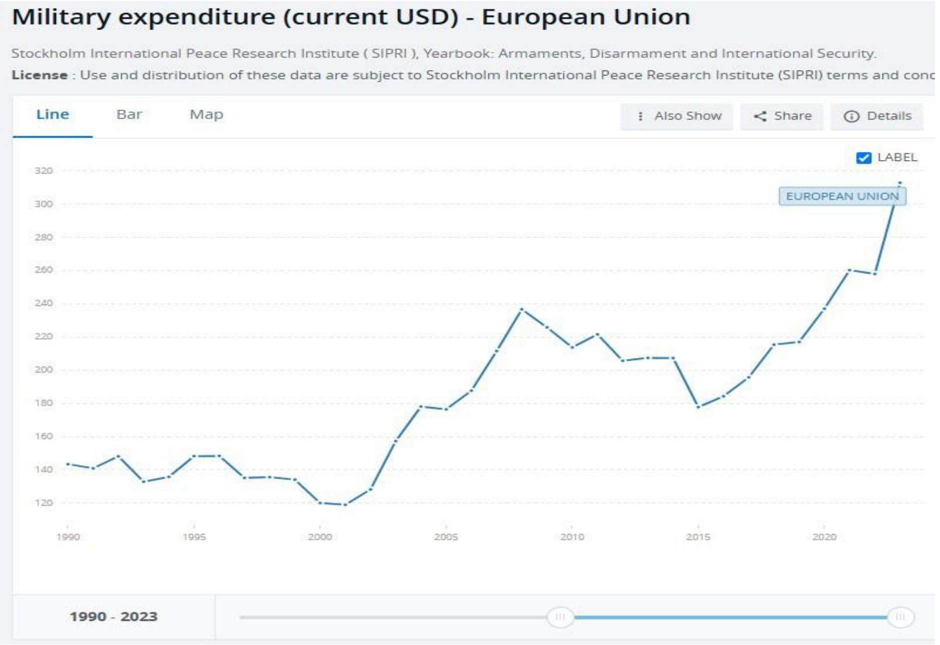
Now go from Europe without to Europe with a security role, and the potential for China centered security alliances

- Seen in Posen (2008) as one reason why the euro would not rival the dollar

the eurozone, and of course it has surged…But the point is that while some economic arguments would suggest that this defense spending differential would likely hasten the euro's displacement of the dollar, through eroding savings and the current account balance, the political view would suggest that at least some of that differential supports the dollar's global role."

- Now put all of that into reverse…
  - Especially against the shift in Europe
  - See Kirkegaard (2025) on future EU defense spending



Systemic Risks for Europe from the New Economic Geography

Systemic Risks from the New Economic Geography

1. Recurrent trade conflicts causing supply and investment shocks
2. Diverging standards (green and beyond) fragmenting production
3. Reduced safety of dollar assets generating ongoing reallocation
4. Decentering of the dollar prompting destabilizing capital flows
5. Rise of the largest EM leaving other LMIEs more vulnerable
6. Increased incentives for lax supervision and financial repression

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Diverging standards fragments production and trade

1. Forced localization of investment for production
2. EU vs US on autos, power generation, housing materials…
3. EU vs US on food/agricultural safety and production
4. China vs US/EU on labor standards in manufacturing
5. China vs US vs EU on data privacy and ownership
6. EU vs US vs China on digital currency and stablecoins

The point of trade rules is to manage divergences – if these are seen as security rivalries, there is no dispute management

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Reduced safety of dollar assets causes ongoing reallocation

Potentially persistently diverging r* between China/EU/US

1) National identity of investors reduces flows of savings
2) Deflation in surplus economies, higher interest rates in deficit ones
    1) Reversal of the savings glut (again, be careful what you wish for)
3) Reduced migration has similar impacts on labor markets
4) Limited cross-border tech diffusion further fragments capital flows
5) Defense spending increases will be higher mostly in deficit economies

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Decentering of the dollar prompts destabilizing capital flows

- Sign reversal of USD x 10-year response to news [Obstfeld (2025); Rey (2025)]
- This is about the eroding quality of insurance that US security and financial relationships *combined* provide – prompting alternatives including self-insurance

1. Narrowing of the gap in EU versus US defense spending
2. Rise of the digital euro to keep payments away from US sanctions, monitoring and security (Lagarde; Lane; Knot; et al, Spring 2025 for ECB)
3. EU domestic vs US imported weapons system purchases
4. US capital inflow/outflow taxes or forced maturity swaps, etc., may come
5. Greater allocations to alternative assets by reserve managers and retail savers
6. Testing of the depoliticized/unconditional Fed swap lines (assurances aside)
7. *Coming rise of alternative swap lines, rebirth of AMF/Chiang Mai…*

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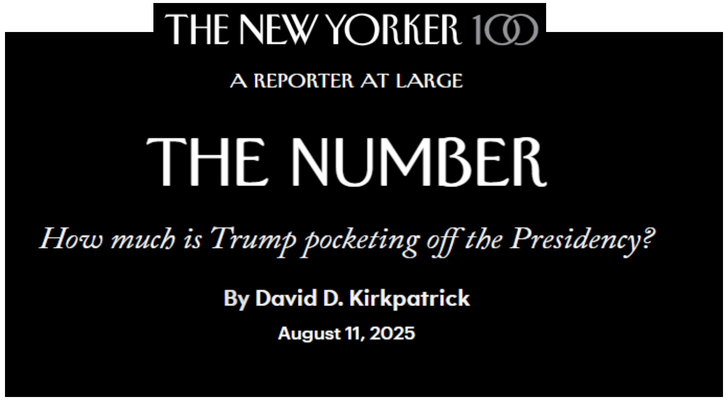
Rise of the largest EM leaving other LMIEs more vulnerable

- Long-term real rates will remain 0.5-1.0% higher than they were before 2020
  - Possible exception of China as lender, but the tied loans are not attractive
- Average growth will be weaker in almost all economies, G20 and LMIEs
  - Likely positive exceptions: Brazil, India, Indonesia, Turkey, Saudi/UAE/Qatar
  - Rest of the BRICS and poorer countries are in persistent difficulty
  - Lack of SIFI financial exposure and of unity means less G20 response to others' problems
- Decoupling of China/US and to lesser degree EU on investment, technology, business networks, and capital flows will be far more harmful than in trade
- Diversification of state-run/regulated portfolios will *decrease*
- Instability in developing world and military build-ups will reinforce each other
- *Renewed round of **capital outflows uphill** furthering gap of biggest EM*

Alternative assets with reduced supervision

- General skepticism of elites and states fed by Trump/populism
- Self-fulfilling but legitimate fears
  - Access to resources
  - Expropriation
  - Monitoring or sanctions
- CBDC draws savings from LMIEs
  - Brunnermeier, James, Landau (2019)
- Competition of different sovereign stablecoins for public debt demand is race to bottom

- Board of Governors of the FRS makes many financial stability decisions without full FOMC
- US is already going it alone on supervision/regulation vs G20
- Trump family/associates have an estimated >$3 billion in crypto



More Euro and More Europe as a New Form of Insurance

Don’t despair! Europe can make things better

25 years BRUSSELS ECONOMIC FORUM

EU Economy & Finance @ecfin

President of @PIIE argued at #EUBEF25 that the way forward for Europe to be itself and play its own game.

By giving the Tommaso Padoa Schioppa lecture, @AdamPosen said "You're not going to win by playing China or the US game."

👉Watch the debate live: europa.eu/!HJmkQJ

Frankfurter Allgemeine

LEHREN AUS DEM ZOLLSTREIT

Europas Ausweg aus der US-Dominanz

GASTBEITRAG von Adam Posen 31.07.2025, 07:08 Lesezeit: 4 Min.

Die Zollverhandlungen haben gezeigt: Die EU ist weniger mächtig als China und die USA. Diese Schwäche könnte zum Vorteil werden, wenn sich Brüssel strategisch geschickt verhält, argumentiert der Präsident des US-Thinktanks Peterson Institute in einem exklusiven Beitrag.

Europe's way forward is to be itself

1. There is a false sense of trade-off between maintaining the multilateral/rules-based and competing with US and China
2. Europe should NOT play their game, play your own game
    1. Much of this is already happening which is GOOD, but be aware
    2. Reaching out in a rules-based spirit with principled plurilateralism
    3. Staying open and avoiding arms-races in industrial policy
    4. Making the most of being relatively open to ROW - and sort of China
    5. Education, R&D, but also development and climate tech sharing
3. Military, green, and migration spending should be centralized
4. Do not mistake this spending for Draghi productivity reform, though – military spending will not promote tech diffusion

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The Euro Area can provide partial insurance

<u>The ECB/ESCB can</u>

- gain in relative safety by staying independent and avoiding conflicts of interest
- continue to promote global usage of the euro (accept rising strength)
- cooperate with governments having capital outflows into Euro CBDC
- team with other CBs to create alternative swap lines (and do so openly)
- encourage a greater share of EA debt issuance to be joint
  - Including Eurobonds a la Blanchard and Ubide (2025)
- commit to non-discrimination by nationality of access to euro liquidity
- hold the line on supervision and regulation of crypto/stablecoins
- include risks arising from USG misbehavior in objective tracking measures

Appendix 1: European productivity outlook

- The common action on debt issuance and defense spending is real and substantial. This will raise European growth and euro vs dollar.
- Whether this results in sustained improvement in the productivity trend, however, is unclear.
- Military build-up in light of Ukraine – both technical and geopolitical considerations – puts a premium on quantity and self-sufficiency (not usually pro-productivity)
- Innovation policy should be thought of as buying a lot of expensive lottery tickets. May or may not pay off, and it takes a while.
- The benefits of innovation come from diffusion and adoption. Military spending does not address the Draghi concerns for scale and integration and might distract from that reform.

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Appendix 2 – Selected References

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Systemic Risks Arising from the New Economic Geography

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