PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

The Global Economy After the Peace Dividend is Gone

Adam S. Posen

President, PIIE

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1750 Massachusetts Avenue, NW | Washington, DC 20036 | www.piie.com

“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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Posen Warns Peace Dividend Is Reversing as Global Tensions Rise

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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 basic problem

1. You had a beach house with good insurance, but now…
2. Ideally, you could pay more for more coverage/higher risk
3. But instead, you are having to pay to insure against insurer
4. While the risks are going up, and your income is going down
5. Shortage of safe assets, not because of low issuance, but eroding quality of existing ones

New economic themes for 2025-2028 and beyond

1. The change in US trade policy and practice is fundamental
    1. Ongoing raised uncertainty level raised as in Brexit
    2. State imposed tactical uncertainty backfires
2. This change will have major impacts on US and global economy
    1. Rising inflation, fiscal expansion, interest rates, financial repression
    2. Disrupting business networks, FDI and migration flows
    3. Depressing growth and credit for the rest of world outside of G20 EM
    4. Decreasing US dollar centrality (initially a step-change down)
3. The need for plurilateralism is to set standards/networks/rules
4. Downside risk of the US becoming an anti-green Galapagos

What came out of the Trump's trade war 1.0

1. US was able to reduce direct reliance on China, but only:
    1. In some (easier to shift) areas of production, and
    2. By US deflecting sourcing to other LMIEs
2. ASEAN and the EU increased direct reliance on China.
    1. These economies are deepening their linkages to China through global value chains.
3. In a beneficially integrated world, tariffs on China alone did not lead to wide or deep decoupling.
4. *Crucially, most private actors and governments hoped this was temporary and reversible. That hope is now largely gone.*

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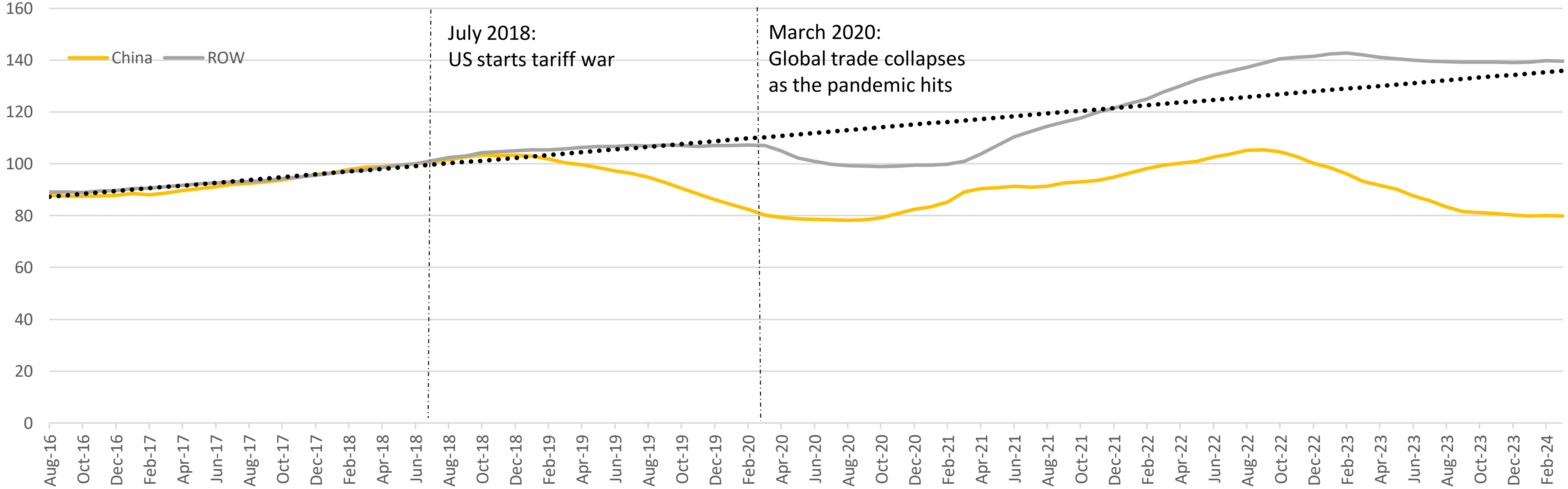
Total US imports from China trended down

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).

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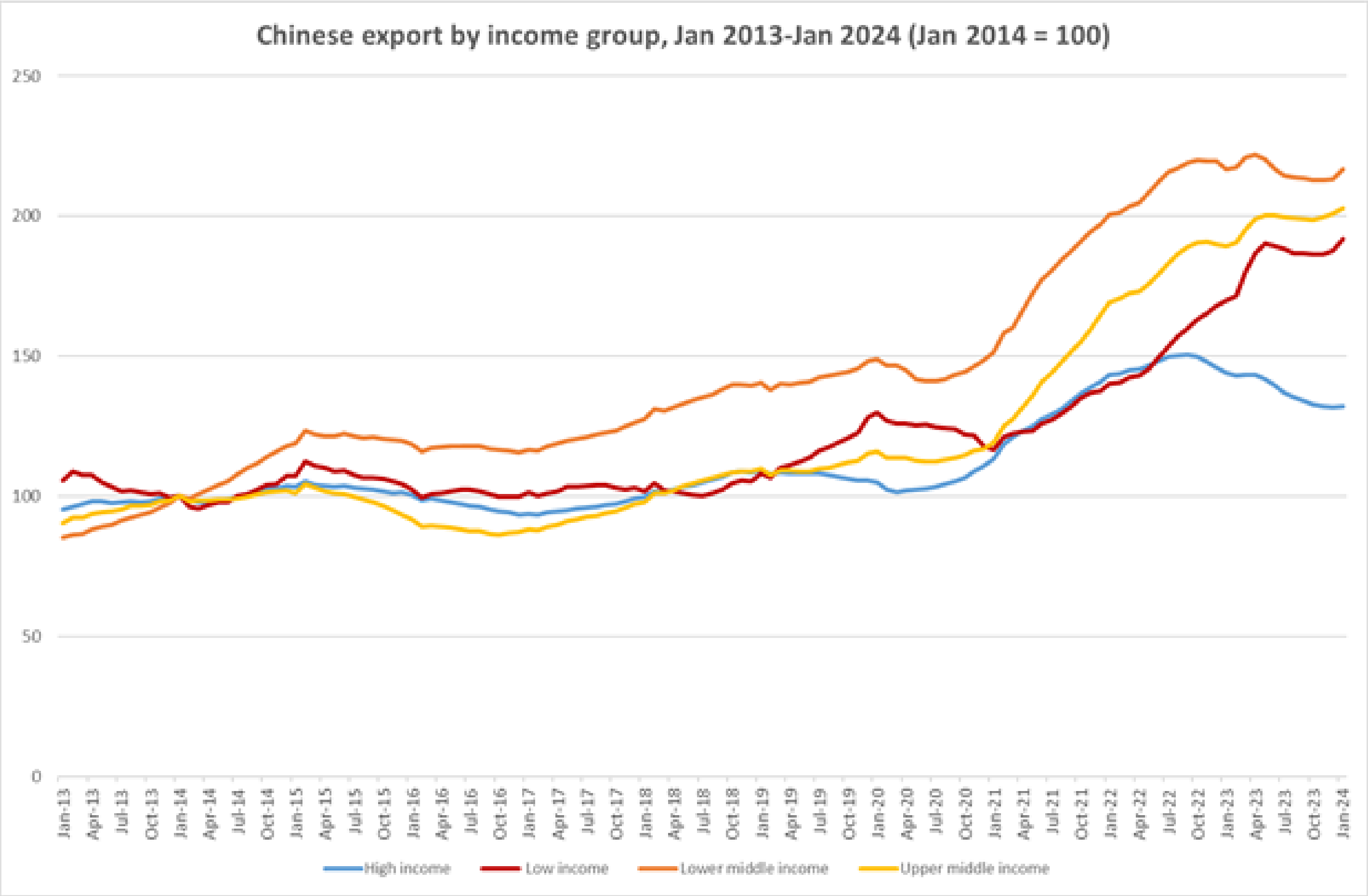
After Trump 1.0, China shifted to new markets



The goals of the new Trump Administration trade policy regime

1. Telling movement members with grievances that fairness is being attained
2. Restoring US dominance in manufacturing *employment* and local sales
3. Closing or reversing bilateral trade balances with surplus holding economies
4. Restructuring international trade relations to maximize US bargaining power
5. Raising significant federal revenues to partially pay for corporate tax cuts
6. Leveraging US market size and power to get non-economic concessions
7. Creating a Commonwealth of like-minded countries aligned with the US

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Where will US tariffs end up? About where we are

Once legislated, tariffs are almost never reversed

Sectors will have little or no exemptions

Reciprocal tariffs mean almost anything goes

25% tariff on Canada and Mexico sets up USMCA issues

Across the board 10-15% tariffs for revenues

Possibly revoking PNTR for China

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What does the Trump Administration want from China?

- Some officials are like Goldfinger to Bond, “Do you want me to talk?” “No, Mr. Bond, I want you to die.” – but that is absurd
- Is the goal to limit foreign influence? To limit territorial expansion? To limit dependence on Chinese production? To forestall Chinese technological progress? To reduce bilateral trade deficits? To deter specific hostile or ‘unfair’ behaviors?
- No one in USG seems to offer China an economic off-ramp – if you do this for us, then we will stop doing that to you.
- **The rest of the world has complaints with China, but they won’t agree to no exit as a policy**

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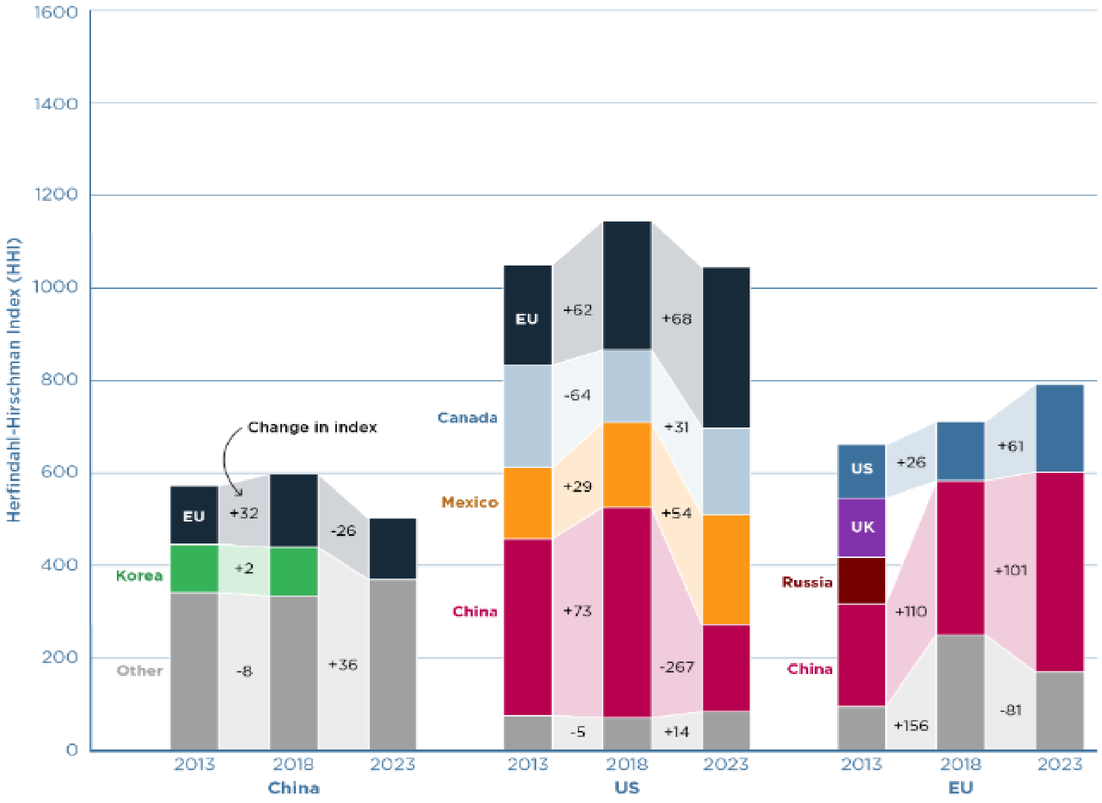
As the US has relied less on imports from China, the EU has imported more

Import concentration indexes for China, US, and EU, all imports, 2013, 2018, and 2023.
Trading partners labeled comprise at least 10% of category imports.



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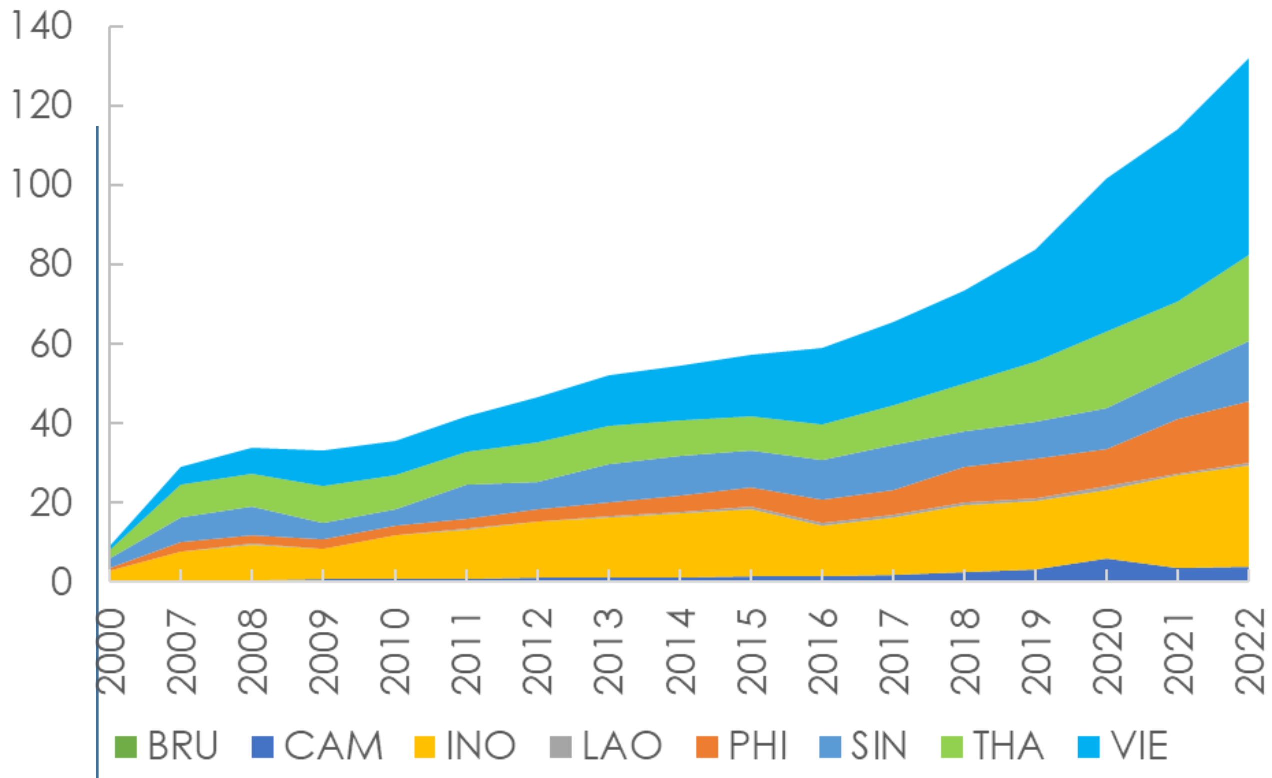
China is a growing source of inputs to Southeast Asia

China's global value chain (GVC) participation is becoming more regional and more diversified.

It is characterized by strong growth in

- purchases of inputs from (backward linkages with) the rest of East Asia
- and sales of intermediate and final goods to (forward linkages with) Southeast Asia

PRC's Forward Linkages in Global Value Chains with Southeast Asia ($ billion, in constant $)



BRU = Brunei Darussalam, CAM = Cambodia, GVC = global value chain, INO = Indonesia, LAO – Lao People's Democratic Republic, PHI = Philippines, PRC = People's Republic of China, SIN = Singapore, THA = Thailand, VIE = Viet Nam.
Source: Albert Park, ADB Multi-Region Input-Output Tables.

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High US retaliatory tariffs hit China’s routes in

- Vietnam – 46%
- Indonesia -- 32%
- India – 27%
- Mexico – 25% (on USMCA non-compliant exports plus pressures vs PRC FDI)
- South Korea – 26%

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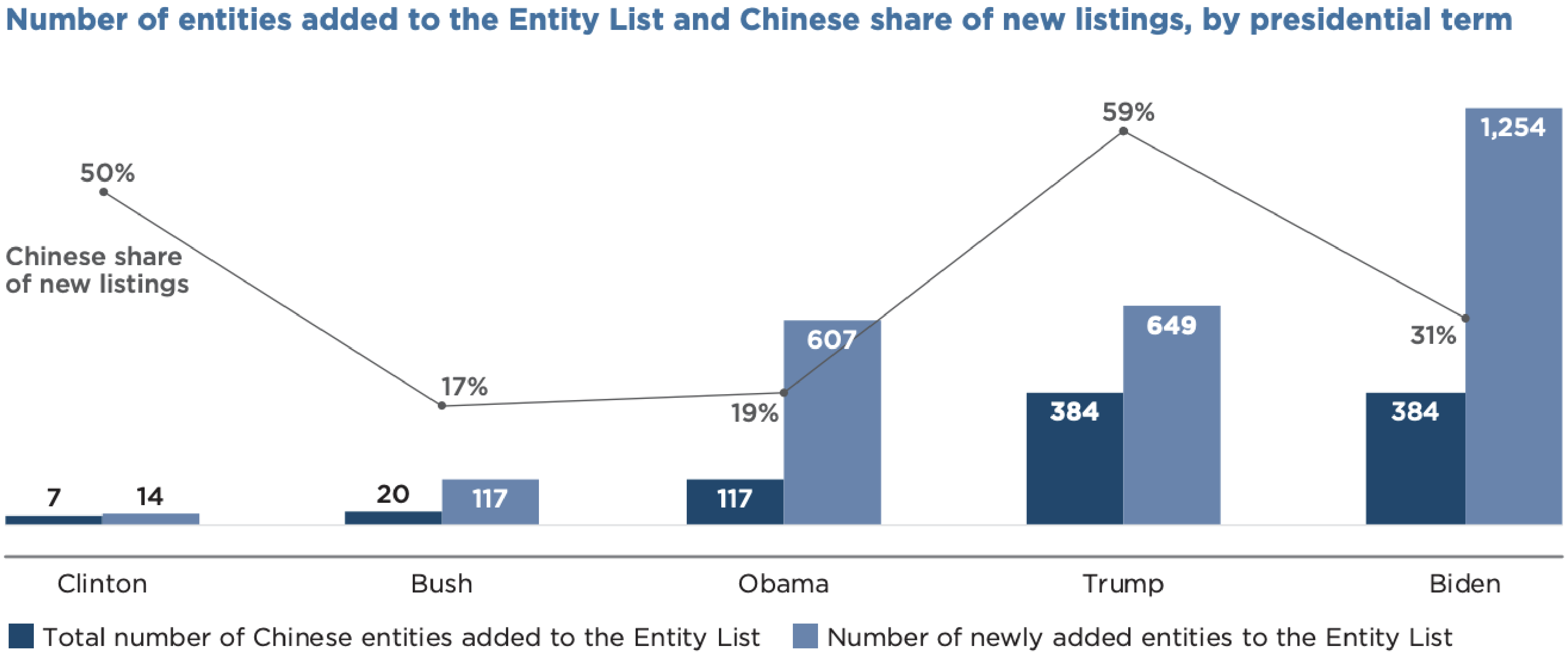
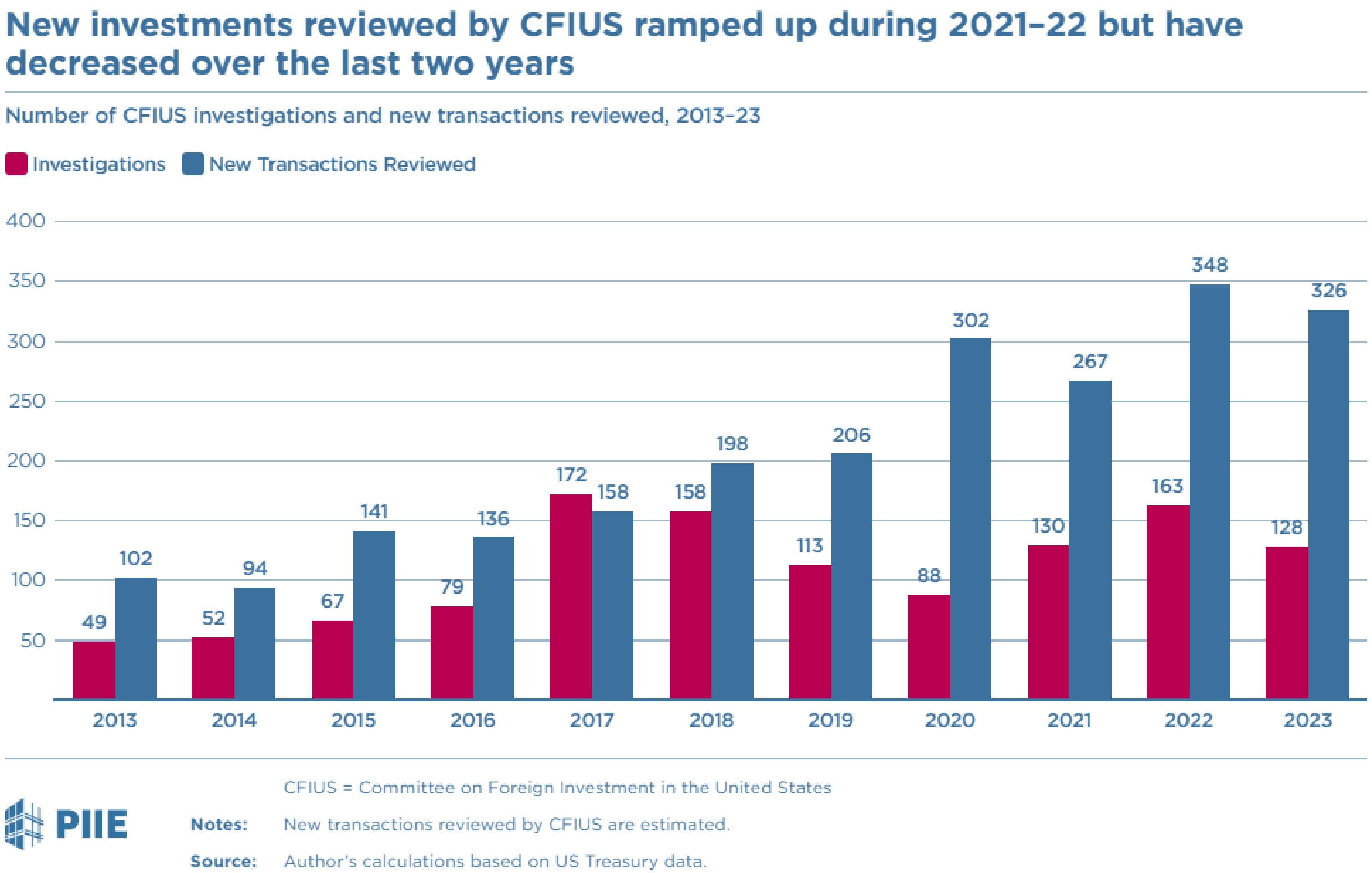
Entity Listings used to control tech exports



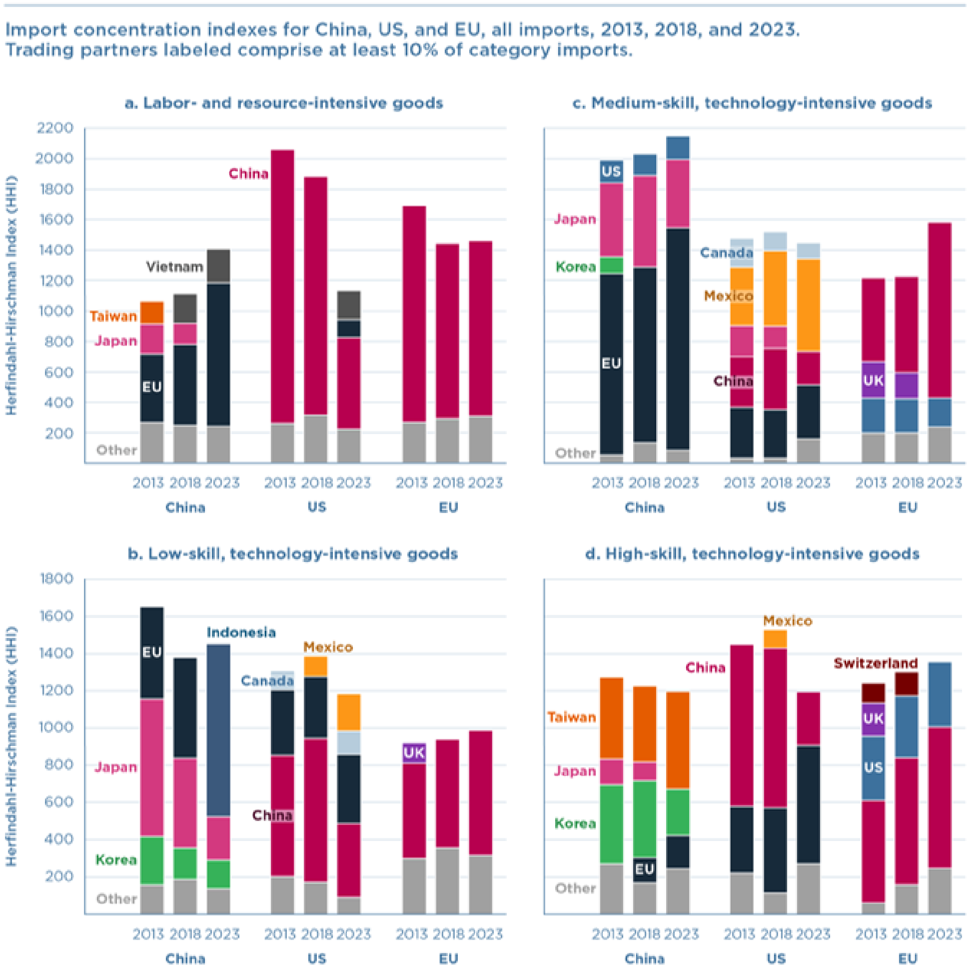
Source: Authors' calculations based on listings from the US International Trade Administration, US Department of Commerce.

Investment Security Reviews on the Rise

- Committee on Foreign Investment in the United States (CFIUS) blocked $121 billion in deals since 2016 (per Martin Chorzempa)
- China is only 10% of reviews under Biden, 14% under Trump—most reviews are on US allies
- Consequence not visible in CFIUS data: foreign firms not bothering or quietly abandoning M&A because CFIUS would reject or be too costly/slow to clear



EU increased its reliance on Chinese tech

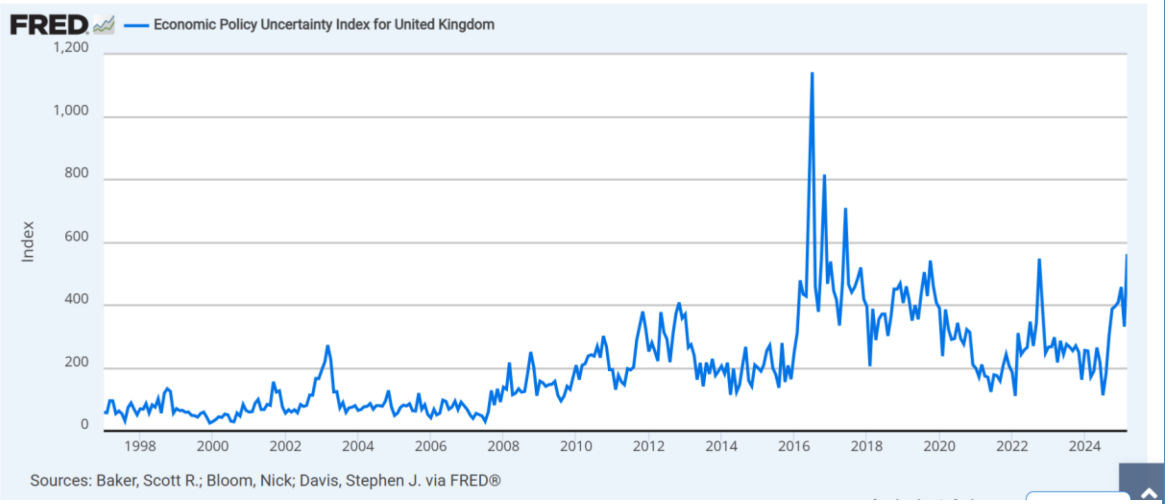


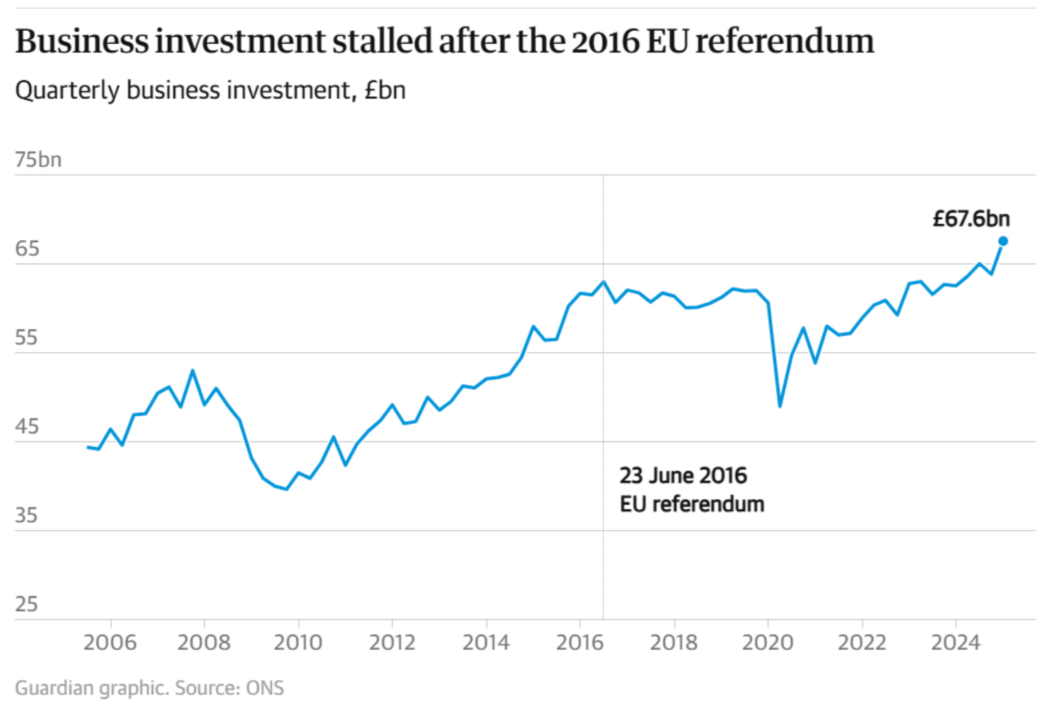
Note: Concentration is measured by the Herfindahl-Hirschman Index (HHI). Degrees of manufacturing are defined by UNCTAD. For consistency, references to the EU pertain exclusively to the EU27, excluding the United Kingdom throughout the analysis period. Sources contributing less than 10 percent to the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

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)*

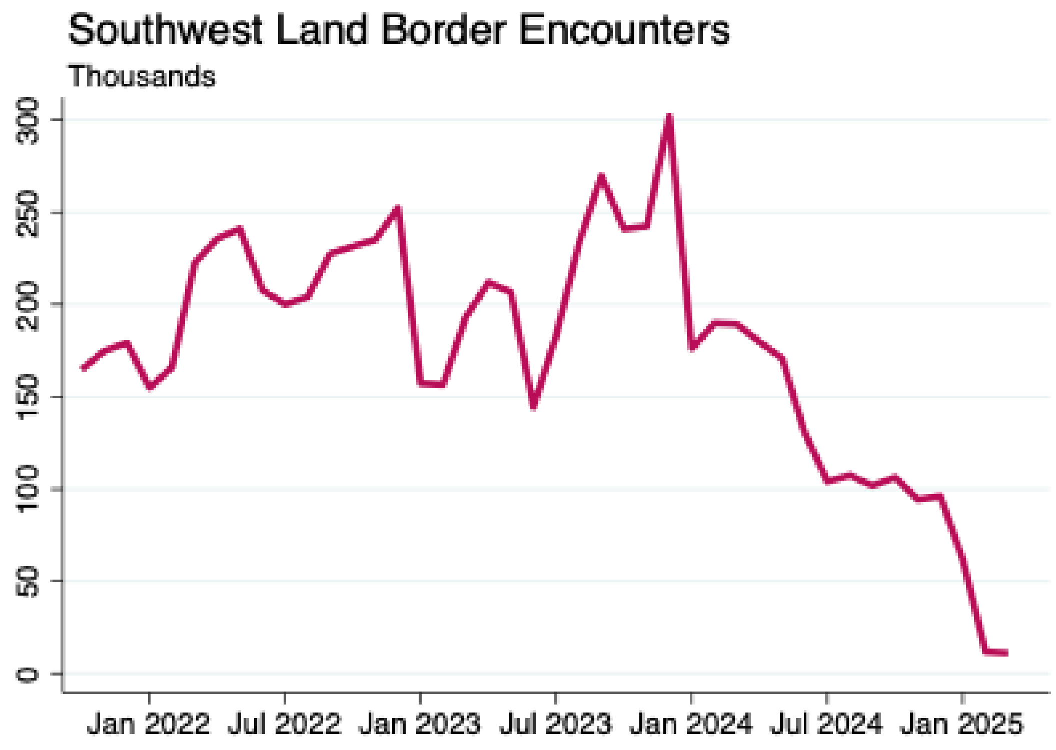




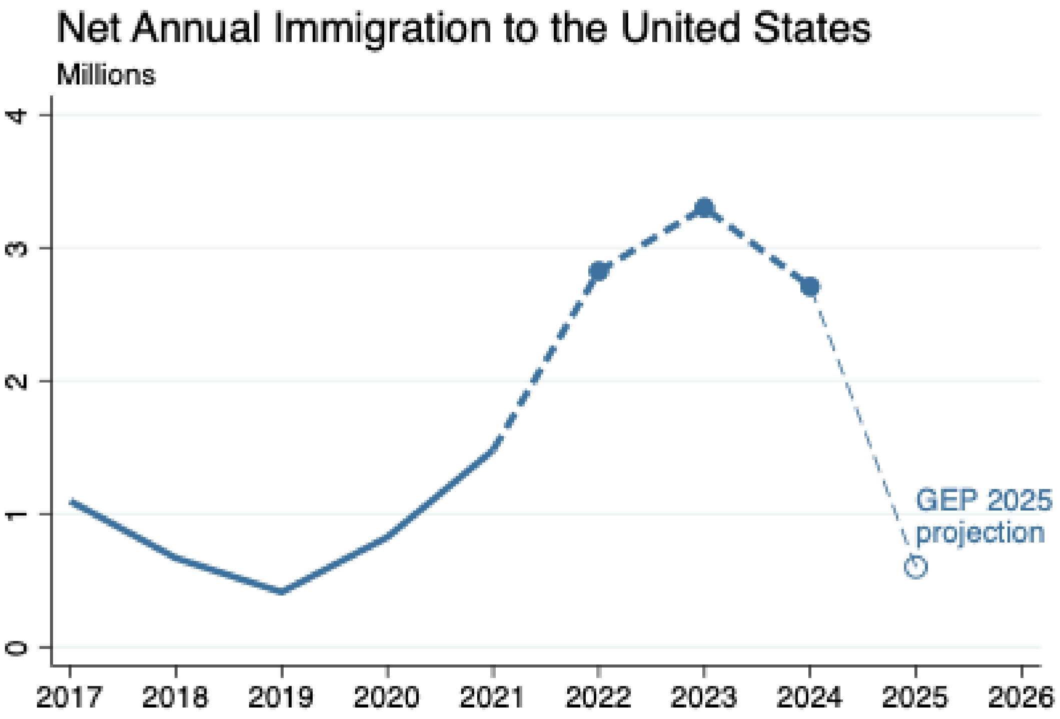
Macroeconomically relevant shortages are emerging and likely to become recurrent

- Housing supply elasticity declines further due to pricier inputs
  - Canadian lumber and other materials; Asian sourced appliances/equipment
  - Migrant (mostly Latin) construction labor
  - Reduced mortgage issuance from Agencies due to policy changes
- DOGE approach to public spending creates uncertainty over the entire Federal workforce and contractors
  - Some specialized public services are very difficult to replace
  - Erodes dependability of infrastructure, which is a cost increase

A drastic reduction in immigration will slow growth in US potential output and demand



Data source: US Customs and Border Protection. Last data point: March 2025.



Data source: Author's projection and Congressional Budget Office 2025 Demographic Outlook. Filled circles are CBO estimates. Hollow circle is GEP projection.

European productivity outlook illustrates that defense spending alone doesn’t solve problems

- 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.

Inflation is coming, whatever the growth rate

Unanchored inflation expectations will be pushed repeatedly

- Fed policy is already too loose, and inflation is too high, to start
- Fed will be behind the curve – especially if there is a recession
- Fiscal excess will worsen – especially if there is a recession
- Deregulation, M&A and exemptions will increase pricing power and therefore pass-through of tariff pricing increases
- Reversal of usual USD capital inflow dynamic, but not conferred on others
- *This isn't transitional adjustment until deals are made - it is a regime of sustained higher uncertainty*

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

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“[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.”

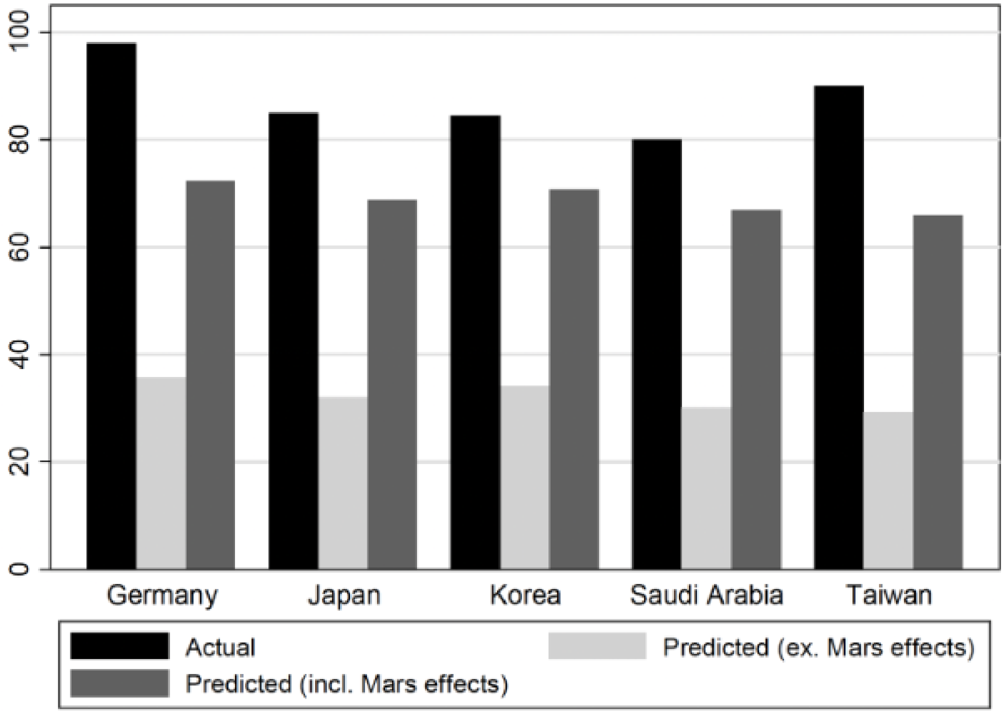
Alliance and security ties previously supported the dollar

- Dollar reliance far outstrips economic/financial explanations
- Missing mass is security ties

  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.

Figure 3 Importance of geopolitical versus pecuniary factors in reserve currency choice: Now

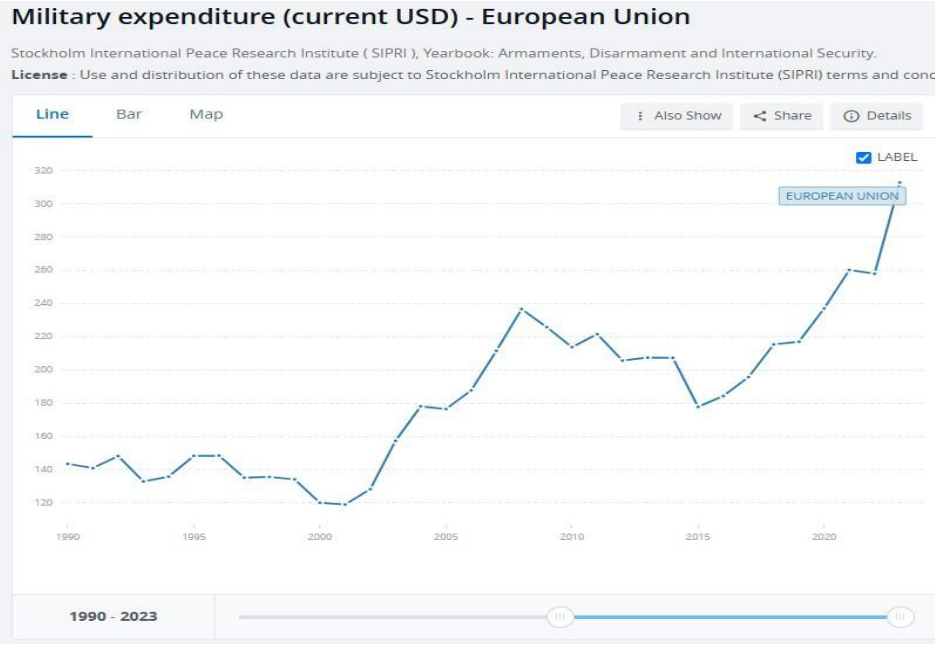


Now go from Europe without to Europe with a security role, and the potential for China centered security alliances

- 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



What to watch for in a reinforcing step-down for $

- This is about the eroding quality of insurance that US security and financial relationships *combined* provide – prompting alternatives including self-insurance
  - Narrowing of the gap in EU versus US defense spending
  - Rise of the digital euro explicitly to keep payments away from US sanctions, monitoring and security (Lagarde; Lane; Knot; all in Spring 2025 for ECB)
  - Divisions over security EU vs US
    - Ukraine, Gaza, Iran
    - EU domestic vs US imported weapons system purchases
  - US capital inflow/outflow taxes or forced maturity swaps, etc., may come
  - Testing of the depoliticized/unconditional Fed swap lines (assurances aside)
  - *Rise of alternative swap lines, rebirth of AMF/Chiang Mai…*

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New economic themes for 2025-2028 and beyond

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The changed macroeconomic financial landscape

- Long-term real rates will remain 0.5-1.0% higher than they were before 2020
  - Possible exception of deflation in China through bottled up savings
- Average growth will be weaker in almost all economies, G20 and LMIEs
  - Likely positive exceptions: India, Indonesia, Turkey, Brazil, Saudi/UAE/Qatar
  - Rest of the BRICS and poorer countries are in persistent difficulty
  - Lack of SIFI financial exposure means less G20 response to others' problems
- Decoupling of China/US and to lesser degree ROW 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
- *Rising fiscal sustainability risks will be partially offset by financial repression given historical precedents*

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Why will U.S. long-rates stay up if inflation comes down?

- Most things that kept r* down from 2007-2019 remain in place, notably:
  - Demographics, risk aversion, and Asian savings glut
  - Forecasts also previously assumed low productivity growth

- A number of things have shifted due to geopolitics and COVID, however
  - G7 and China will increase fiscal spending on defense, green, and industrial policy
    - Reversing the Cold War Peace Dividend, worth ~0.7% increase
  - Fragmentation of global financial markets will trap savings in China and reduce available savings in the West – net is higher rates in US transmitting elsewhere
  - Risk aversion has been reduced in US in response to YOLO and safety net
  - Productivity growth trend has arguably increased – if the previous 2 years were not a blip

⇨ US 10-year Treasury average real rate will *increase* over the next few years

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Implications for monetary policymakers

1. Capital flows will be subjected to greater volatility *and* blockages
    1. Remittances/migration flows will be similarly disrupted
2. Consumer growth will reallocate to large EM, ASEAN, and to a lesser degree to EU periphery
    A. Market and trend growth will slow in US, PRC, and rest of LMIEs
    B. Manufacturing, however, may be full on sold to Chinese FDI
3. Pressures on central bank independence – and specifically for direct purchases of public debt – need to recognized
4. Scenarios planning will not deal with the real challenges, which are having to discern the inflation persistence after supply shocks
5. Alternative assets and CBDCs will get into active competition

Appendix – Selected References

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Adam S. Posen
aposen@piie.com

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