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Military spending in Europe on the rise

What can other countries learn from Poland's transition experience?

The European Union after the Draghi Report: Too powerless to reform

US tariffs on Canada, China and Mexico and their effect on Central and Eastern Europe

The Vienna Institute for International Economic Studies
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GRZEGORZ W. KOLODKO
ANDREAS LICHTENBERGER
OLIVER REITER

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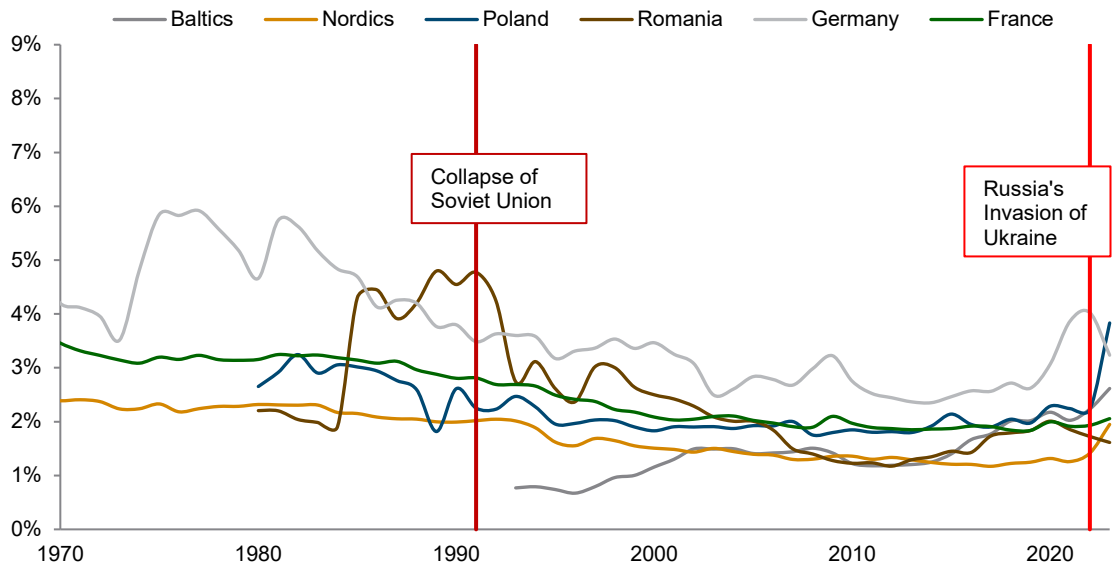
Chart of the Month: Military spending in Europe on the rise

BY ANDREAS LICHTENBERGER

Figure 1 / Military expenditure in selected European countries as a share of GDP (in %)



Notes: Baltics: unweighted average of Estonia, Latvia and Lithuania; Nordics: unweighted average of Denmark, Finland and Sweden.
Sources: SIPRI (2024), own calculations.

Following a decline of over three decades, Russia's war on Ukraine has led to a spike in military expenditure in many European economies (see Figure 1). For the Baltic states, as well as countries like Poland and Romania, the war has underscored the urgency of maintaining a robust defence, as their strategic position makes them susceptible to potential encroachment. Membership of the North Atlantic Treaty Organization (NATO) represents a fundamental aspect of their defence strategy. However, those nations still prioritise investment in their own military capacity, viewing it as essential for their rapid response capability. Such policies are part of a broader strategy on the part of those states to affirm their sovereignty and deter potential future aggression.

Amidst the current split in transatlantic unity, it is to be expected that military expenditure in Western Europe will rise (although in the Baltics and Poland, there is probably not much room for any further increase). A pro-Ukrainian attitude among many European leaders and revitalised ambitions in Germany to reform the so-called debt brake also support these dynamics. An increased appetite for military spending is likewise reflected in the financial sector: share price of companies in weapons and manufacture metals (such as Rheinmetall) have been soaring ever since the US elections in early November 2024.

Opinion Corner*: What can other countries learn from Poland's transition experience?

BY GRZEGORZ W. KOLODKO[1]

In times of great turbulence in the world and the European economies, it is worth looking at the example of the greatest European success in development policy: Poland over the last three decades. Furthermore, Poland is still the fastest-developing country in Europe. It is worth looking at what policy mistakes were committed and how the country's success came about. Others could benefit from this knowledge.

From the perspective of the developing countries of the Global South, the most illuminating example is provided by China and its unprecedented success in catching up economically. Hardly surprising, then, that the leaders of so many African countries converged on Beijing on 2 September to attend the 2024 summit of the Forum on China–Africa Cooperation (FOCAC), in search not only of ways to achieve bilateral and multilateral win-win cooperation, but also of how they might learn from the remarkable Chinese achievements.

But I believe they could also learn from the Polish transformation experience. The events of 1989 in Poland and the subsequent positive economic processes triggered by those political shifts could be useful today for countries as diverse as Bangladesh and Thailand, Egypt and Algeria, Nigeria and South Africa, Ecuador and Venezuela. Reasonable policies require healthy compromise; good policies need both dialogue and compromise. It is well worth learning from those countries that have a record of huge achievement in this.

Back in 1989, Poland was already at the forefront of pro-market reform. Especially in the second half of the 1980s, unlike in other centrally planned socialist countries, favourable conditions were created for accelerating the transformation. State-owned and cooperative enterprises enjoyed increased autonomy and, though the country did not yet have a market economy, it was certainly no longer centrally planned. Once a network of commercial banks was split off from the National Bank of Poland (which had functioned as a monobank), a decentralised banking system began to operate. The foreign exchange market was liberalised – fully for households and partially for businesses. Since the summer of 1989, more than half of all goods (in terms of value) have been sold with free pricing.

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* Disclaimer: The views expressed in the Opinion Corner section of the Monthly Report are exclusively those of the authors and do not necessarily represent the official view of wiiw.

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In the late 1980s, there were laws regulating the inflow of foreign direct investment, anti-trust laws and regulations on company bankruptcy. Poland was a member of the General Agreement on Tariffs and Trade (GATT) and in 1986 became a member of the World Bank and the International Monetary Fund. In the late 1980s, Western countries accounted for more than half of Poland's foreign trade turnover; over 20% of national income was generated by the private sector. No socialist country at the time enjoyed such advanced decentralisation and deregulation or such a wide range of private enterprise. At the same time, the situation was unfavourable, with the worst 'shortageflation' syndrome of all the socialist countries – the efficiency-sapping coexistence of open price inflation and permanent shortages.

The year 1989 heralded a historic chain of events. After the inconsistent pro-market reforms of the state socialist system, the country experienced a political about-turn that enabled the process of systemic transformation to be pushed forward irreversibly: between 1990 and 2024, Polish GDP grew on average by 3.3% a year. Although it has become popular in certain circles to praise the 'shock therapy' pursued in the country in the early part (1990-1991) of that timeframe, it should be noted that it also includes the period 1994-1997 – when the 'Strategy for Poland' programme was in full swing and when Polish GDP grew by an average of 6.4%. Although far lower than the economic growth seen in China, that is still well above the growth attained in other post-socialist economies or in the rich Western countries.

The 'Strategy for Poland', which was implemented after the failure of the so-called shock therapy (during which time GDP contracted by almost 20%), was a medium-term development programme linked to structural reform and the establishment of social market economy institutions. The programme was based on four pillars: rapid economic growth, fair distribution of income, effective state intervention and beneficial integration with the world economy. The Strategy itself consisted of 14 specific programmes: from combating unemployment to encouraging partnership-based labour relations to the security of economic turnover; from investing in human capital to reforming the social security system; from ownership transformation to the development of the financial sector; from the development of rural areas to the international competitiveness of the economy; from introducing Poland to the Organisation for Economic Co-operation and Development (OECD) to integration with the European Union. A critical feature of this programme was its comprehensiveness.

The Polish breakthrough spread quickly, inspiring not only the entire Central and Eastern European region to engage in profound systemic change, but also stimulating liberal reforms in distant parts of the world. Within Poland itself, the move rendered it possible to pursue an economic policy that had previously been blocked due to internal social resistance and the foreign sanctions imposed on Poland in the wake of the introduction of martial law at the beginning of the 1980s. Unfortunately, the overly radical liberalisation and the excessive severity of the stabilisation package introduced in 1990, instead of limiting the scale of price increases, actually accelerated them. The government offered its assurance that month-on-month inflation would be as low as 1% after just one quarter; yet that figure was reached only after seven years. The government promised a shallow one-year recession; but in fact it lasted for three years (from the second half of 1989 to the first half of 1992) and GDP fell by a combined 20%. Unemployment was not supposed to rise any further once it reached 400,000; but it eventually topped 2.5 million and only started to fall after four years. As a result of combating the 'shortageflation' syndrome with shock therapy, industrial production fell by almost a third, and prices rose almost twelvefold.

The ineffectiveness of shock therapy was highlighted by Nobel laureate Joseph Stiglitz. In reply to the question: 'Poland is now converging on Western European living standards. Does that show that shock therapy simply can work if you stick with it?', Stiglitz answered:

> No, I think it shows quite the opposite, and I've had a lot of discussions with the architects of Poland's you might call 'miracle'. The reasons Poland is the most successful of the Eastern European countries are several, but it was not the shock therapy that had such a negative macroeconomic effect. It was the fact that after that moment of shock, they began a gradualistic policy of reform, of creating the institutional infrastructure that is the basis of the market economy … It was really their walking away from shock therapy after a very short period and moving to this gradualist policy that was the foundation of their success in this now three decades since the beginning of the transition from communism to a market economy.[2]

That is right. If the policy mistakes of the early 1990s that proved so very costly from the point of view of economic development had been avoided, the GDP of Poland – and consequently the standard of living of its people – would already have been significantly higher. Instead of lying between Portugal and Czechia with a per capita income of around USD 50,000 (in purchasing power parity), Poland could already be enjoying a per capita income of over USD 60,000 and be somewhere between Finland and France.

[2] 'Joseph Stiglitz on pioneering economic theories, policy challenges and his intellectual legacy', *Conversation with Tyler,* 26 June 2024, https://conversationswithtyler.com/episodes/joseph-stiglitz/.

The European Union after the Draghi Report: Too powerless to reform

BY HUBERT GABRISCH

In light of the emerging conflict between the US and China, the Draghi Report describes a catastrophic state of innovative capacity in the European Union. The reaction of the European Council and the Commission offers little hope that this state of affairs can be properly rectified.

The story of the EU's economic decline, as measured by the Union's weak GDP growth and innovation – whether in absolute terms or relative to the US and China – is hardly new and in the past has prompted various reports and proposals on behalf of the EU Commission. Two important reports were published last year. One was the Letta Report (*Much More Than a Market*)[1] published in April; its main proposals seek to supplement the four freedoms of the internal market with a 'fifth freedom' – the free mobility of researchers and innovators, in order to create a European Technology Infrastructure. The second was the Draghi Report, consisting of two parts (A and B), which was published in September under the title *The Future of European Competitiveness*.[2] Its proposals include greater centralisation and coordination of tasks, with joint borrowing and annual investment of at least EUR 800bn for innovation, decarbonisation and economic security, including defence. With a strong focus on measures to overcome the lack of innovation, it builds on the Letta Report – but goes well beyond measures to promote the mobility of researchers.

THE EU IS SET TO LOSE OUT IN THE UPCOMING DUEL BETWEEN THE US AND CHINA

The particular relevance of the Draghi Report lies in the dramatic changes taking place in the geopolitical environment in which the EU finds itself. With the re-election of Donald Trump, a US-China duel is emerging much more strongly than before. It will initially be fought with protectionist measures; and the EU, which is deeply devoted to the idea of free trade, risks ending up even further down the losers' road. With a foreign trade ratio of 50% of GDP, the EU is much more dependent on the global market than are its two main rivals (China: 37%; US: 27%). The growth rate of the EU's GDP at market prices fell from 3.9% in the year 2000 (the first year of the single currency) to 0.4% in 2023. In economic terms, the yields of the European economy can be said to have fallen sharply. An escalating trade war would push the EU's economic growth further towards the zero line, as market share would be lost.

1 https://www.consilium.europa.eu/media/ny3j24sm/much-more-than-a-market-report-by-enrico-letta.pdf

2 https://commission.europa.eu/document/download/97e481fd-2dc3-412d-be4c-f152a8232961_en?filename=The%20future%20of%20European%20competitiveness%20_%20A%20competitiveness%20strategy%20for%20Europe.pdf. This link relates to Part A.

The effects would not be limited to the economic and social sphere but would also affect the acceptance of democratic forms of government. In today's world, no democratic nation can be isolated from information about living conditions in the rest of the world. And a democracy can only survive if its leadership makes a credible promise to its citizens and classes to ensure a level of prosperity that is higher than in non-democratic regimes. If this promise is not credible, conflicts could erupt that blow asunder the democratic order and the Union itself. China has always been ruled in an authoritarian manner, and the US under Trump could follow suit. But the desire for authoritarian leadership is also growing in other parts of the world, including in most member states of the European Union. Ultimately, that can only end in protectionism. In fact, the economic data make the promise of the European ruling elite – that the EU will offer ever greater prosperity – appear less credible. After all, since the introduction of the euro 25 years ago, there have been no ground-breaking reforms in the EU that could fuel hopes of closing the Union's growth and innovation gap with the US and China. Therefore, European leaders should actually be mounting a powerful push for reform.

What has been the reaction of the EU's leadership (i.e. the European Council and the European Parliament) to the two reports? So far, there has been only a muted declaration from the Budapest Summit of the Union in November 2024 on the 'New European Competitiveness Deal';[3] this, however, does nothing to boost expectations. Although the two reports mentioned are 'welcomed' – as if they were surprising proposals – no concrete objectives or even priorities are listed for the various projects. The rhetoric ranges from 'must' to 'necessary' to 'we are ready' and 'we are determined' – this is the polite language used when the differences between the governments of the member states seem insurmountable. After all, the Council kindly 'asked' the Commission to submit proposals for the implementation of the New Deal by April 2025. On 27 November 2024, Commission President Ursula von der Leyen announced a Competitiveness Compass, which was to be based on the Draghi Report; this compass has been available since 29 January 2025.[4]

FINANCING MIRACLES

This brings us to the first key question: how to finance the EUR 800bn or more per year that the Draghi Report considers necessary to meet all three main objectives – innovation, decarbonisation and security. This huge sum would mean a leap in the EU's investment ratio from the current 22% of GDP to 27%. If this cannot be achieved, the only option is to set priorities. The fact that the Council cannot avoid setting priorities becomes clear when one looks at the proposals on financing in the Draghi Report and in the Commission's concept. Both papers mention – first and foremost – the strengthening of private capital and the financial markets through the completion of the Banking and Capital Markets Union and the mobilisation of private savings for investment, particularly through the reform of pension systems. The pay-as-you-go pension system that is common in most EU member states should be supplemented by a funded system, so that assets can be built up there and transferred to the capital markets. The Banking and Capital Markets Union should be able to make these available for investment throughout Europe. In other words: no investment without prior savings!

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3 https://www.consilium.europa.eu/en/press/press-releases/2024/11/08/the-budapest-declaration/

4 https://european-research-area.ec.europa.eu/sites/default/files/documents/2025-01/COM%202025%2030%20-%20A%20Competitiveness%20Compass%20for%20the%20EU%20_%2029-1-2025.pdf

But the Banking and Capital Markets Union, conceived as a reaction to the euro debt crisis of 2011-2013, has only been partially implemented; and even those parts that have been implemented have not been able to overcome the weak growth of the EU. This is hardly surprising – not least because one of the reasons for the sluggish implementation of these projects so far has been the obstacles raised by governments that are sceptical of mobilising domestic pension assets for foreign private capital market financing. Moreover, financing exclusively via the private markets and the use of securitisation as the main instrument of risk-sharing may fail in time of crisis, because banks, shadow banks and other capital market intermediaries will immediately reduce their provision of financial resources ('deleveraging'). The reason for this is their fear of contagion effects. There is a risk of a systemic crisis because, as financial institutions become ever more interconnected, this risk of contagion can increase after the failure of just one network participant. But it is precisely at this time that financing is particularly needed. If private financing is to be made largely crisis resistant, what is missing is the fiscal 'backstop', i.e. supplementing private risk-sharing with permanent public risk-sharing at the central EU level. There have been demands voiced over many years for such an instrument, but it has so far been rejected because it would require changes to the EU treaties.

The progress that the Draghi Report actually offers is that, in addition to private financing, there should also be public financing at the central and national level. At the same time, however, it considers the chances of financing from the EU budget to be low, as that budget accounts for only around 1% of EU GDP. An expansion in the EU budget on an unprecedented scale would also require the amendment of EU treaties and would certainly encounter resistance from many national governments and parliaments. In this respect, the proposal to guarantee funding through common 'safe assets' is neat, but highly unlikely to be effective. The only remaining option is a coordinated effort by the member states to raise the sum required via their budgets, which would mean taking on more debt. However, with over 150 'debt brakes' and budget restrictions in the EU, some with constitutional status, coming up with an additional EUR 800bn is hardly realistic. The debt brake regulations would therefore have to be reformed, although the current discussions in Germany alone leave little hope of this.

ILLUSIONS ABOUT 'LESS BUREAUCRACY'

In the last section of Part A, the Draghi Report addresses the strengthening of governance – i.e. what is commonly known as the EU's bureaucratic control and regulatory system. And therein lies the second central problem: on the one hand, we read that a reduction in bureaucracy is regarded as necessary; on the other hand, in its previous sections the report proposes the creation of new bodies to coordinate efforts. The principle of subsidiarity should apparently be strengthened; but there is no detail on what should be done, where and how.

In Part B (p. 318), the report offers a telling detail: between 2019 and 2024, the EU (Commission and Parliament) passed around 13,000 pieces of legislation: of these, 515 were ordinary legislative acts, 2,431 were other legislative acts, 954 were delegated acts, 5,713 were implementing acts and 3,442 were other acts. In the same period, only 3,500 pieces of legislation were passed at the US federal level. This huge discrepancy attests to the widely divergent national preferences in the EU, the harmonisation and monitoring of which are reflected in these political and legislative acts. Many different preferences increase the cost of consensus-building, through the expansion of central bureaucracy – additional functionaries, new expert panels and subpanels, the organisation of meetings, and the drafting of

minutes and other texts. In general, the increase in legal and political output reflects not only cross-country heterogeneity, but also an increase in bureaucracy. The most important proposal in the Draghi Report is the establishment of a new Vice-President of the Commission for Simplification – a new authority, with officials from all member states and expert groups.

THE ELEPHANT IN THE ROOM

The third central problem involves the alteration of EU treaties, which have remained unchanged since 1999, when the Lisbon Treaty was adopted and the Union consisted of 14 member states. Are they still up to date, now that the EU has 27 members? Advocates of change are concerned primarily with the Union's inability to act in the face of internal and external crises. But the issue of treaty change is like the famous elephant in the room: everyone sees it, and yet it is ignored – in this case by the European Council, the Commission and Brussels think tanks. It is true, the Draghi Report states (Part A, p. 59): 'Strengthening the EU requires Treaty changes' – only to continue in the same sentence with the following strange logic 'but it is not a precondition for Europe to move forward'. Only one of those two statements can be correct!

The Draghi Report also favours an extension of Qualified Majority Voting (QMV), which is undoubtedly important, but is not a new proposal. And if this cannot be achieved by reforming the treaties, then the so-called 'passerelle clause' should be used to bypass vetoes in further European Council policy areas through the back door, so to speak. As we know, this clause can only be set in motion by a unanimous vote in the Council. But why should a member state that is generally opposed to EU regulations that restrict its sovereignty agree to this if it fears being outvoted on an important issue – such as defence policy or sanctions against third states? This is a problem that will certainly not diminish with future enlargements of the Union.

WHAT REMAINS?

In view of the funding, bureaucracy and governance problems, two possible alternatives for the European Council's New Deal are emerging.

The first is to abandon the whole idea of EU central public funding, reduce EU bureaucracy, strengthen the principle of subsidiarity and thus increase competition between member states. Voices in favour of this alternative seem to come mainly from certain Central and Eastern European countries, which are generally opposed to further centralisation of measures and their funding at the EU level. However, these voices overlook the fact that a significant obstacle is actually not the EU bureaucracy, but rather the various national bureaucracies. There are stories of start-ups with technologically highly innovative products that take three years or more to be authorised, because each country has its own separate rules (I have in mind here an Irish company that produces mobile fast-charging stations for electric cars).

The second alternative is prioritisation. Since this would be a political decision, it would be up to not the Commission, but the Council (plus Parliament). Substantial compromises would then have to be made in one of the three target areas – innovation, decarbonisation and security – resulting in the postponement of certain tasks. Obviously, you can't have everything. As the 'innovation' part is very likely to be

prioritised, the only remaining option would be a competition for finance between decarbonisation and defence; and in the case of the latter, sovereignty issues are very likely to be raised.

The Commission complied with the Council's 'request' and, on 29 January 2025, presented a fairly detailed compass for the competitiveness of the EU.[5] It is important to note, however, that the Commission's position is that of an implementing authority: it is not authorised to decide on funding or treaty changes – those responsibilities are reserved for the Council and Parliament. While the Commission calls for a combination of bureaucracy reduction and prioritisation at the national level, the important question of feasibility (given the Commission's limited competence) is omitted. Although the goal of climate neutrality by 2050 is not to be abandoned, in my view, implementation measures will be postponed.

No mention is made of the Draghi Report's proposals regarding new sources of revenue for the EU budget and the use of new financing models ('safe assets'); instead, the mobilisation of private savings via the Banking and Capital Markets Union is to be used to promote innovative technologies, which is also the focus of the Council's declaration. The Commission's new idea here is a Savings and Investment Union to complement the – still unfinished – Banking and Capital Markets Union. Any hope that this third union could help narrow the innovation and productivity gap is forlorn: because it is not savings that determine investments, as the Commission believes, but investments that determine savings!

Regarding the allocation of more money for the small EU budget, it should be remembered that the next Multiannual Financial Framework (in which EU budget relevant measures should be reflected financially) will apply only from 2028. Hence, the urgency of the Draghi Report, which actually suggests a prompt adjustment to the current framework, is not particularly apparent. In this context, the Commission would probably prefer to coordinate national fiscal policies, as if the rocks of the various debt brakes were not in the way! And the 'omnibus laws' announced by the Commission President to simplify the rules can, of course, only apply at the EU level and not the national level. There is a danger that, by misusing the subsidiarity principle, bureaucracy will migrate from the EU to the national level.

In conclusion, unfortunately, it can be said that solutions to the sensitive problems of the European Union role in the world are presented far too timidly in the Draghi Report for the Council and Commission to find the strength required for the necessary institutional reform of the EU.

[5] https://ec.europa.eu/commission/presscorner/detail/en/ip_25_339

US tariffs on Canada, China and Mexico and their effect on Central and Eastern Europe

BY OLIVER REITER AND JAVIER FLÓREZ MENDOZA

We use a state-of-the-art trade model to estimate the effects of a trade war initiated by the US against Canada, China and Mexico, as well as possible implications for the countries of Central and Eastern European of retaliation by those three countries. We find that while positive welfare effects are possible, those would be due to rising tariff revenues; real wages, however, are always lower compared to the situation without a trade war.

INTRODUCTION

Right from the start of his campaign to become president, Donald Trump repeatedly stated his plan to raise tariffs – frequently involving different countries or different tariff increases.[1] One idea he floated was to hike tariffs on European exports to 10% and tariffs on Chinese exports to a massive 60%. Even Mexico and Canada – along with the US, the other two members of the USMCA free trade agreement – found themselves in the firing line.

On 31 January, President Trump announced a series of new tariffs: 25% on products from Canada and Mexico and an additional 10% on goods from China, on the pretence of using this trade policy move to counter illegal immigration and importation of the drug fentanyl.[2] One day later, the tariffs on Canada and Mexico were paused for a month, as the two countries agreed to step up their border controls.[3]

In this article, we use the state-of-the-art trade model proposed by Caliendo and Parro (2015) to estimate what such a change in US trade policy quantitatively for the European Union, and especially for its Central and Eastern European member states. Furthermore, we investigate the effects of retaliation by China, which has already been announced.[4] will respond with similar tariff increases of 25%.

TRADE MODEL OF CALIENDO AND PARRO AND SCENARIO SET-UP

The model by Caliendo and Parro (2015) is a Ricardian trade model. Its main equation relating trade flows to characteristics of the exporting and importing countries mimics a structural gravity equation. However, in contrast to structural gravity models (such as those described in Yotov et al., 2016 and Grübler and Reiter, 2021), the Caliendo and Parro model does include input-output linkages; thus any

1 See, e.g., https://apnews.com/article/tariffs-trump-taxes-imports-inflation-consumers-prices-c2eef295a078a76ce2bb7fedb0c5e58c or https://www.factcheck.org/2024/11/trumps-agenda-tariffs/

2 See https://www.whitehouse.gov/fact-sheets/2025/02/fact-sheet-president-donald-j-trump-imposes-tariffs-on-imports-from-canada-mexico-and-china/

3 See https://www.bbc.com/news/articles/c87d5rlee52o

4 See https://edition.cnn.com/2025/02/04/business/china-us-trade-retaliation-hnk-intl/index.html

increase in the exports of a certain good will also increase the flows of its intermediate inputs (which might again be international trade flows). Hence, with this design we can model the effects of trade policy changes on global value chains – something that is not possible using a structural gravity model. See, for example, Flórez Mendoza et al. (2024) for a recent application of the model to the EU carbon border tax issue.

The model is based on the OECD inter-country input-output database (see OECD, 2023). It covers 77 countries and 45 industries. The database includes data for nearly all the model variables: international trade flows, input-output coefficients, shares in final demand and so forth.

Furthermore, we use estimated trade elasticities from Fontagné et al. (2022) and Eppinger et al. (2023) for the goods-producing industries, while the elasticities for the service sectors are taken from Freeman et al. (2021). These elasticities are computed for the long term. Since we are interested in the short term, we divide them all by four, as proposed in Baqaee et al. (2024). Finally, trade data were collected from the World Integrated Trade Solution (WITS) platform of the World Bank (2023) and were cleaned and used in Cieslik and Ghodsi (2024). We use data from the year 2020, which is the latest year for which all data sources are available.

As in the latest announcements by President Trump, we assume that the US increases its tariffs on Chinese products by 10%. Products from Canada and Mexico will be subject to 25%, with exports from the Canadian mining industry facing a reduced tariff of 10%. China has already announced that it will impose the following retaliatory tariffs: mining products from the US will be charged a 15% tariff, while the tariffs on machinery, vehicles and transport equipment will be increased to 10%. In the case of Canada and Mexico, we assume that they will retaliate by imposing a tariff of 25% on US products. Services are not subject to tariffs.

OUTCOME FOR WELFARE AND REAL WAGES

Figure 1 shows the estimated effects on welfare and real wages for a set of selected countries. The blue bars show the effects when the US starts the trade war, and the orange bars depict the effects of a possible tariff hike in retaliation for the US increases. The orange bars thus only show the additional change (relative to the blue bar).

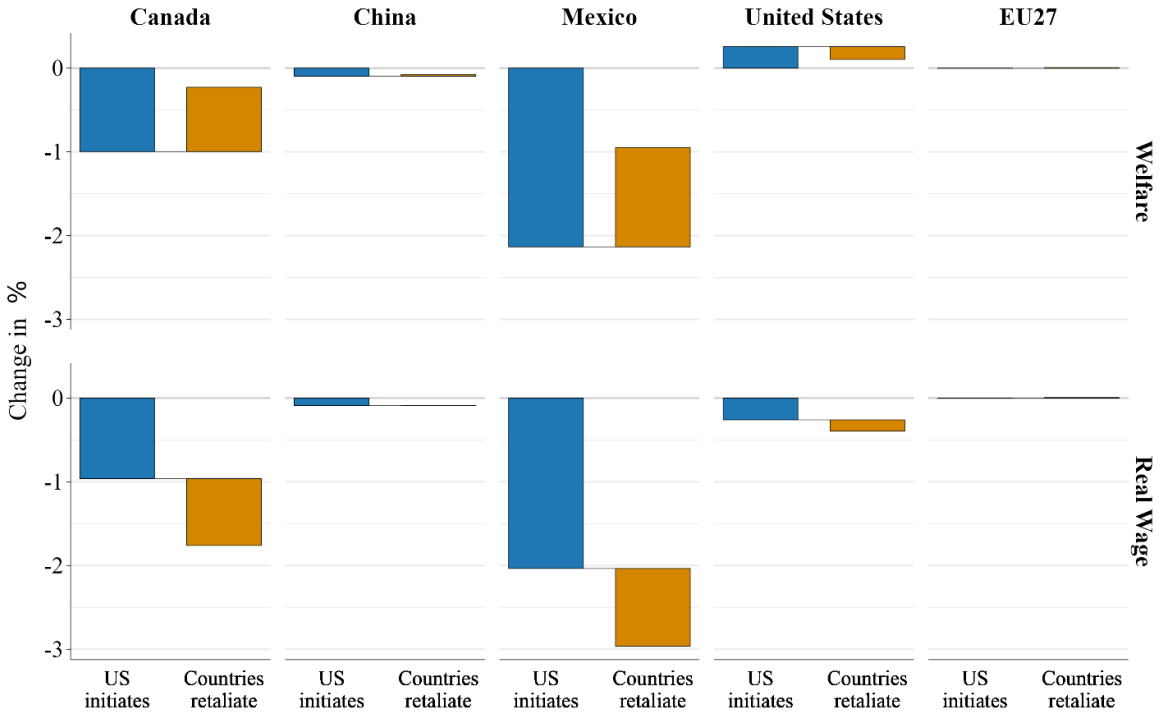
As stated above, we employ short-time elasticities for this model estimation. It is, however, important to note that this does not translate to a time interval over which these effects would take place: with the model we can compare the ‘real’ economy in 2020 with a hypothetical 2020 economy in which these trade policy changes are already in effect.

We can see from Figure 1 that in terms of welfare,[5] the biggest change resulting from increased US import tariffs will be in the two countries closest to the United States: Canada’s losses resulting from the initiation of a trade war by the US will amount to roughly 1% of real GDP (blue bar). For Mexico, the GDP losses will be slightly more than 2%. However, for China the additional 10% tariff will reduce its GDP by only 0.1%, clearly demonstrating a trade relationship that is less close (than Mexico’s or

[5] In the Caliendo and Parro (2015) model, welfare can be regarded as measuring real GDP, since it is the change in total national real income (i.e. the sum of real wages and real tariff income).

Canada's). The US itself will gain slightly from the tariff increases: 0.25%, according to our model. Note, however, that the benefits to welfare come mostly from additional tariff revenues, as the model assumes that tariff revenues are lump sum transfers to households (which is highly unlikely to hold true in the real world). The US gain, however, is also due to improving terms of trade, because the price of exports rises relatively more than the price of imports. The EU, as a bystander, would see only a minuscule change in welfare – a reduction of 0.003%.

Figure 1 / Estimated changes in welfare and real wages due to trade policy changes: the US, Canada, Mexico, China and the EU



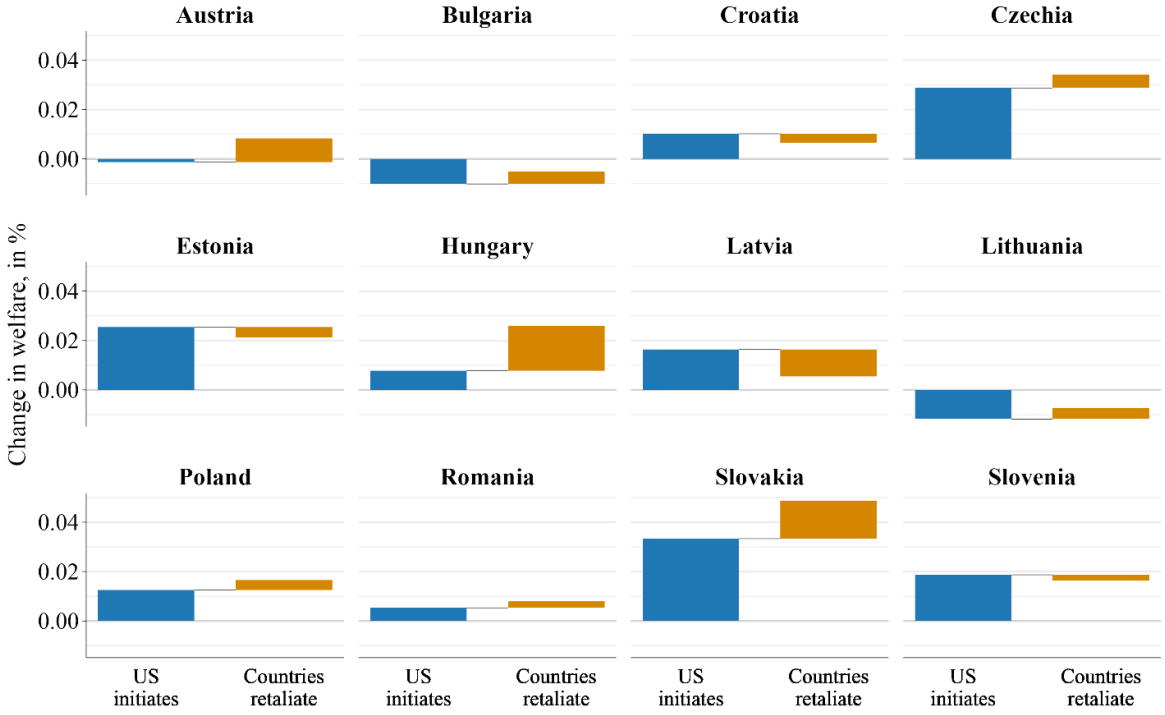
Source: wiiw calculation.

However, when the three countries retaliate (orange bars in Figure 1), the outcomes reverse their signs: Canada, China and Mexico recoup some of their welfare losses (again mostly due to additional tariff revenues in this scenario). China is set to see a welfare gain of 0.02%, resulting in an overall welfare loss of 0.08%. By retaliating, Canada could reduce its welfare losses to 0.22% and Mexico to 0.95%. Meanwhile, the EU could experience a marginal welfare increase of 0.005%.

Since revenues from increased tariffs are unlikely to be transferred direct to households, a better indicator of the effect of tariff increases on households is to look at the change in real wages. And on that score, we can see that – since tariff increases raise the cost for consumers of foreign goods – real wages fall almost everywhere and thus consumers bear most of the cost. Even in the US, where welfare rises when the country imposes tariffs on Canada, China and Mexico, real wages fall. This is due to the increasing cost of inputs sourced from abroad. The EU countries are the exception here: real wages could rise by 0.006% after the retaliation, thanks to reduced import prices.

The results for Austria and 11 Central and Eastern European countries (Figure 2) are broadly similar to those for the EU.

Figure 2 / Estimated change in welfare due to trade policy changes: Austria and Central and Eastern Europe



Source: wiiw calculations.

Of all the EU countries, the welfare gains when the US initiates a trade war are greatest for Slovakia. Other major beneficiaries are Czechia, Estonia, Hungary and Slovenia. The mechanism behind these welfare movements can easily be explained: US tariff increases will mean that prices of exported goods from Canada, China and Mexico fall a little, which will also benefit European importers and consumers. At the same time, the US will import more from the EU countries. By contrast, Bulgaria and Lithuania will experience a small welfare loss from the US initiation of a trade war that is only partly reversed through retaliation by Canada, China and Mexico. Austria's welfare would decline by a minuscule 0.001%, turning into a welfare gain of 0.008% after retaliation.

The effects of retaliation by Canada, China and Mexico tend, in absolute values, to be lower than the effects of the initial tariff hikes by the US, and their signs are more mixed (eight countries see a welfare increase, and four a decrease).

OUTCOME FOR SLOVAKIAN EXPORTS

We now look at the changes in exports following each of these trade war episodes, focusing specifically on Slovakia, since it is the EU country with the biggest estimated rise in welfare.

Table 1 shows the estimated percentage change in Slovakia's exports arising from the trade war episodes between the US, Canada, China and Mexico. The column 'US initiates' states the change from the 'baseline' scenario (no tariff increases by the US). The column 'Canada, China and Mexico retaliate' shows only the incremental change resulting from the retaliation of those three countries; thus these figures are relative to the scenario where the initial tariff increases are already in place. Finally, 'Total change' shows the overall change in Slovakia's exports (compared to the baseline scenario) when all four countries in question – the US, Canada, China and Mexico – have increased tariffs.

Table 1 / Estimated change in Slovakia's exports, by country

Exporter	Importer	US initiates	Canada, China and Mexico retaliate	Total change
Slovakia	US	9.7%	-1%	8.6%
Slovakia	Canada	-9.4%	18.7%	7.6%
Slovakia	China	-1.8%	0.5%	-1.2%
Slovakia	Mexico	-15.3%	10.5%	-6.4%

Source: wiiw calculations.

We can see from Table 1 that Slovak exports increase most to the US and Canada. When the US first imposes tariffs on Canada and Mexico, US firms import more from Slovakia (third column), and Slovak firms export less to Canada and Mexico. However, when these countries retaliate against the US, Mexican and Canadian firms shift some of their imports away from the US and import instead from Slovakia, thus compensating for part of the previous reduction in exports: exports to Mexico would increase by 10.5% (-6.4% in total) and exports to Canada by as much as 18.7% (+7.6% in total). For exports to China, the pattern is the same as for exports to Canada and Mexico, though the magnitude is smaller. In total, exports from Slovakia to China would decrease by 1.2%. Exports to the US would also fall by 1% after the retaliation, resulting in an overall rise in exports of 8.6%.

CONCLUSION

In this article we have analysed the changes in welfare, real wages and trade that can be expected if the US starts a trade war by imposing import tariffs on goods from Canada, China and Mexico. We also model the outcome of the retaliation by China and of possible retaliation by Canada and Mexico.

Our findings show that while increasing tariffs leads to welfare gains for the US, this is mainly on account of increased tariff revenues, which are assumed in the model to be redistributed direct to households. We believe it unlikely that this assumption would hold in the real world. Retaliation helps the affected countries to recoup some of their welfare losses – again on account of increased tariff revenues. In terms of real wages, every tariff hike hurts consumers in all countries (including the initiating country) by raising the price they must pay for products; this clearly demonstrates the negative effects on households of a trade war.

So long as the EU remains just a bystander in the evolving trade war, the welfare and real wage impacts for it are very small. (This would, of course, be different if the EU were directly targeted by US import tariff hikes.) However, the initiation of a trade war by the US and retaliation by Canada, China and Mexico are estimated to lead to a shift in the export patterns of EU countries. As an example, we have taken the case of Slovakia. The retaliation offsets some of the trade diversion that stems from the initial tariff increases by the US. The different trade structures of the various EU countries mean that the trade diversion and welfare gains vary from country to country.

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The monthly and quarterly statistics cover **23 countries** of the CESEE region. The graphical form of presenting statistical data is intended to facilitate the **analysis of short-term macroeconomic developments**. The set of indicators captures trends in the real and monetary sectors of the economy, in the labour market, as well as in the financial and external sectors.

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Conventional signs and abbreviations used

%	per cent
ER	exchange rate
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices (for new EU member states)
LFS	Labour Force Survey
NPISHs	Non-profit institutions serving households
p.a.	per annum
PPI	Producer Price Index
reg.	registered
y-o-y	year on year

The following national currencies are used:

ALL	Albanian lek	HUF	Hungarian forint	RON	Romanian leu
BAM	Bosnian convertible mark	KZT	Kazakh tenge	RSD	Serbian dinar
BGN	Bulgarian lev	MDL	Moldovan leu	RUB	Russian rouble
BYN	Belarusian rouble	MKD	Macedonian denar	TRY	Turkish lira
CZK	Czech koruna	PLN	Polish zloty	UAH	Ukrainian hryvnia

EUR euro – national currency for Montenegro, Kosovo and for the euro-area countries Estonia (from January 2011, euro-fixed before), Latvia (from January 2014, euro-fixed before), Lithuania (from January 2015, euro-fixed before), Slovakia (from January 2009, euro-fixed before), Slovenia (from January 2007, euro-fixed before) and Croatia (from January 2023, euro-fixed before).
Sources of statistical data: Eurostat, National Statistical Offices, Central Banks and Public Employment Services; wiiw estimates.

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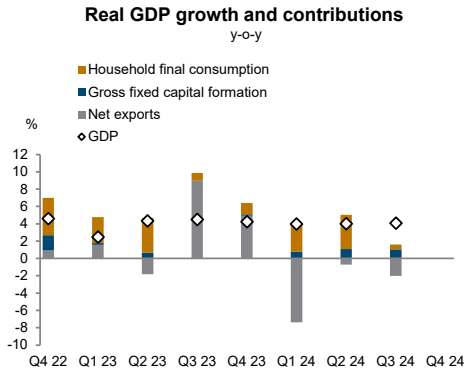
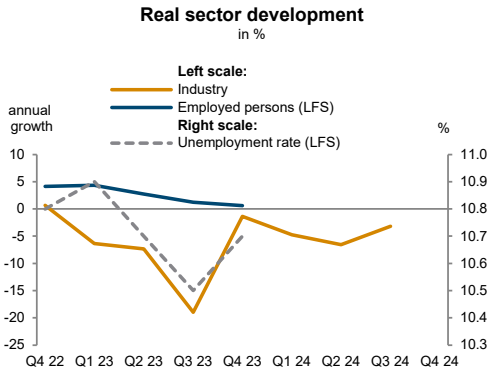
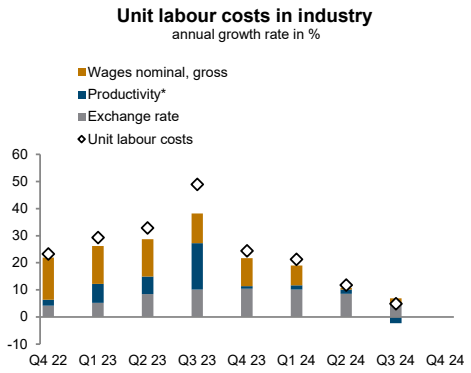
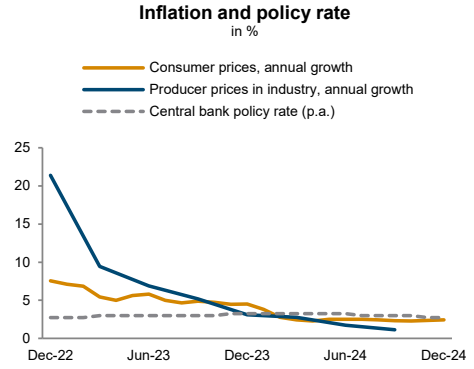
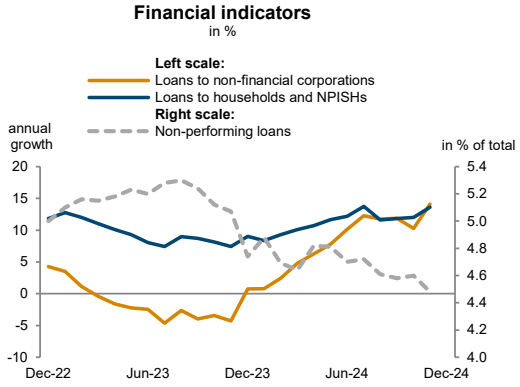
Albania

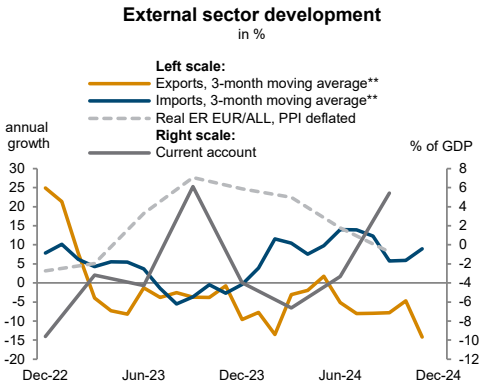












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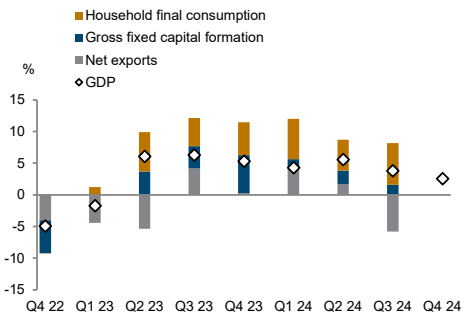
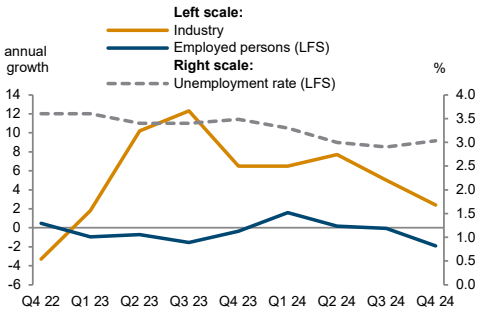
Belarus

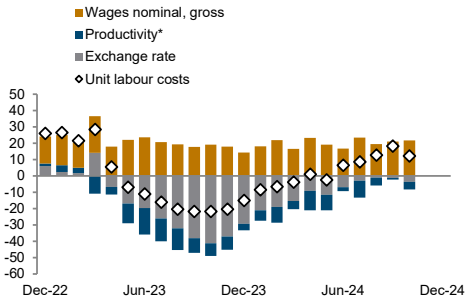
Real GDP growth and contributions
y-o-y



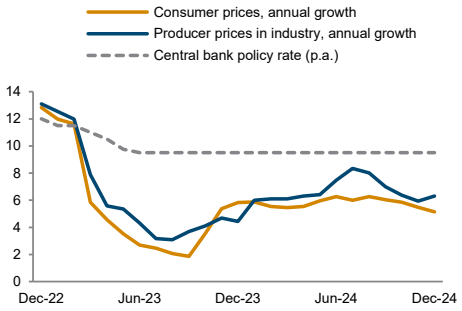
Real sector development
in %



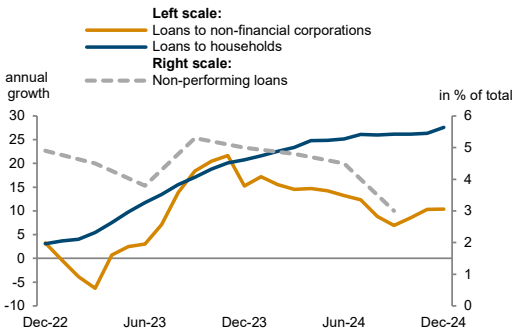
Unit labour costs in industry
annual growth rate in %



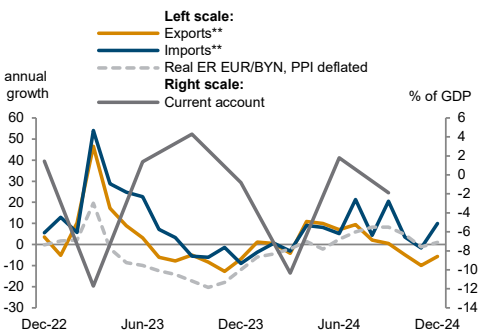
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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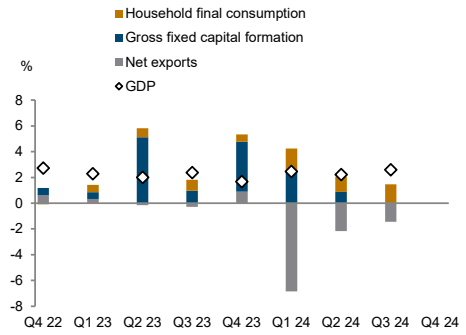
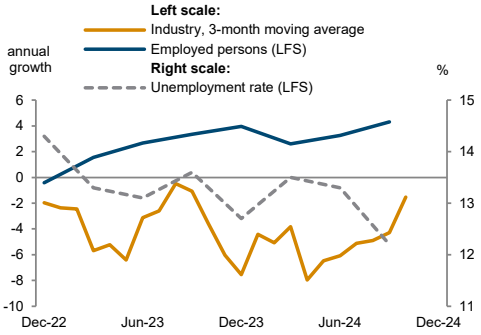
Bosnia and Herzegovina

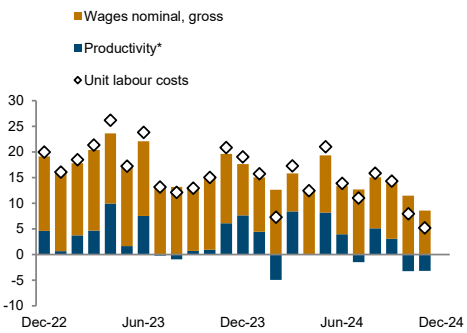
Real GDP growth and contributions
y-o-y



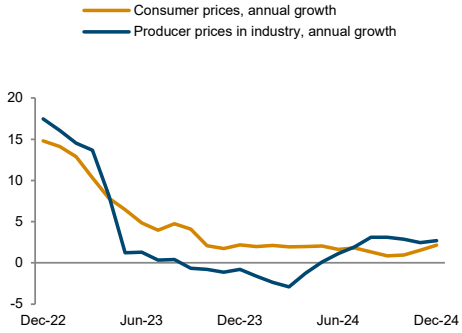
Real sector development
in %



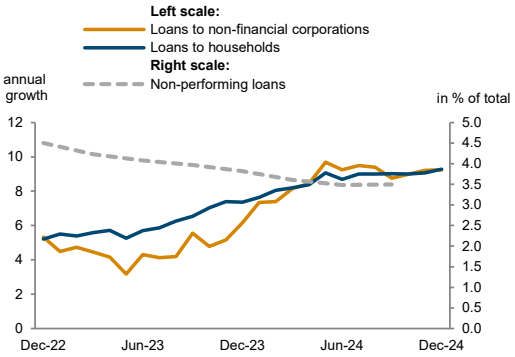
Unit labour costs in industry
annual growth rate in %



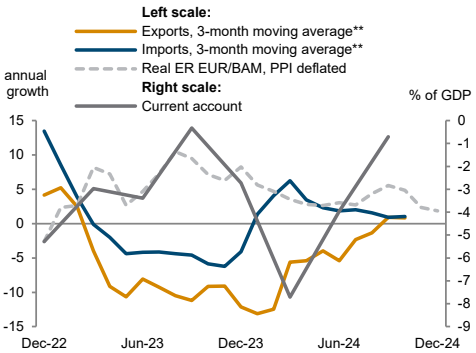
Inflation
in %



Financial indicators
in %



External sector development
in %



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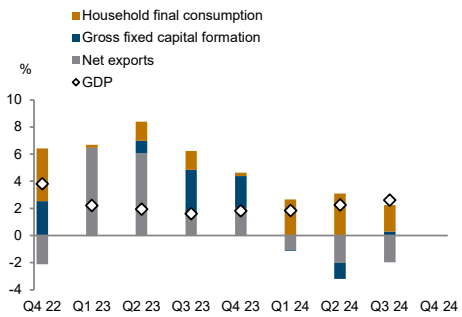
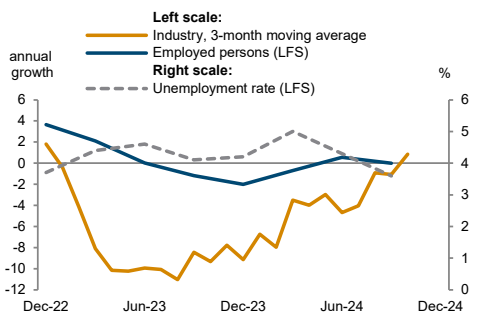
Bulgaria

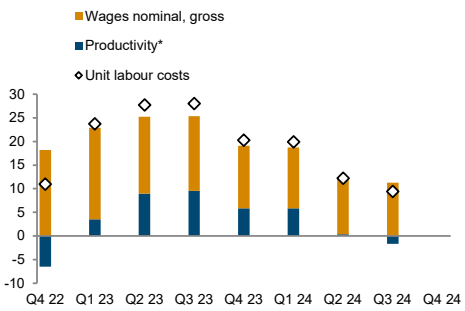
Real GDP growth and contributions
y-o-y



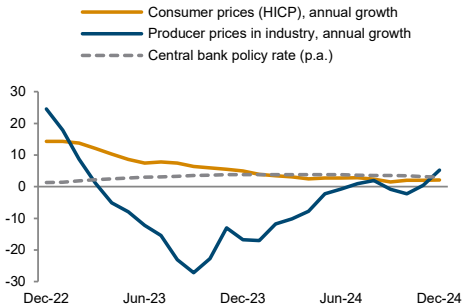
Real sector development
in %



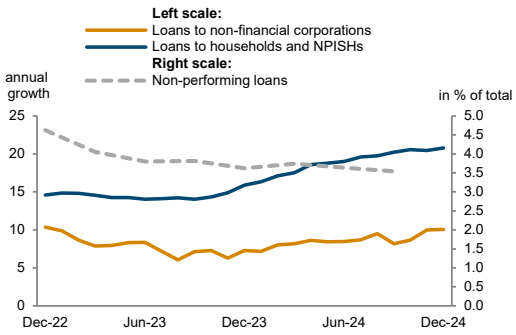
Unit labour costs in industry
annual growth rate in %



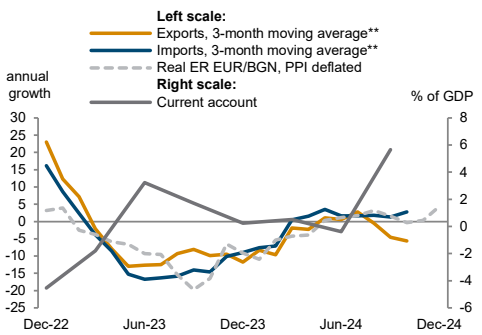
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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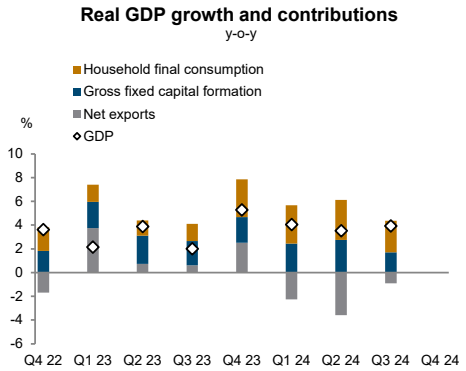
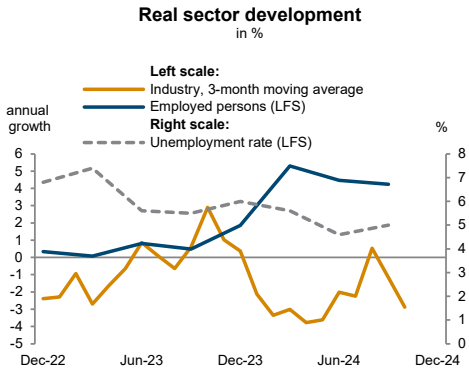
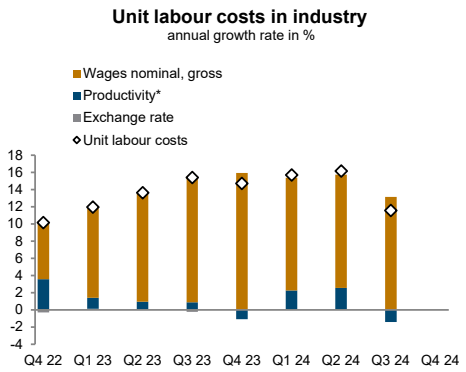
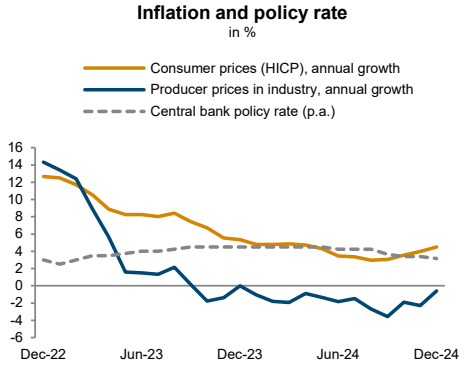
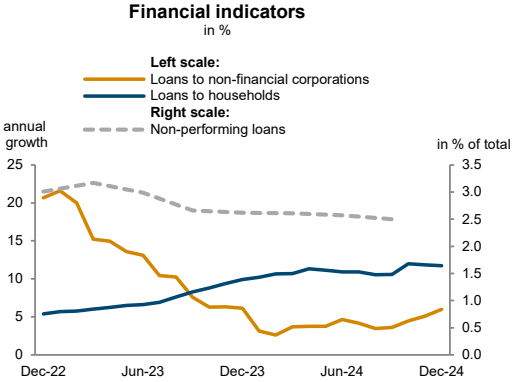
Croatia

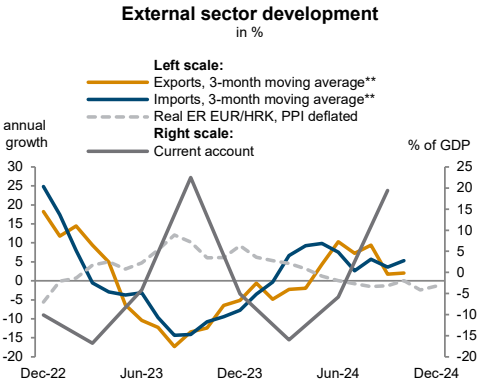












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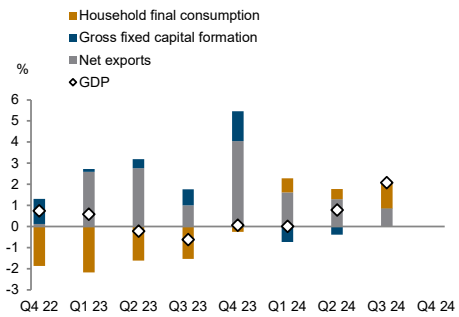
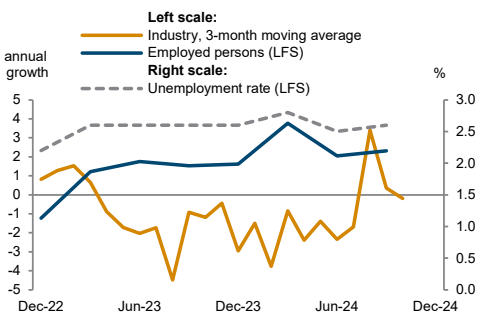
Czechia

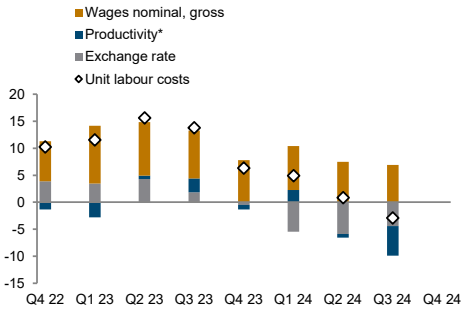
Real GDP growth and contributions
y-o-y



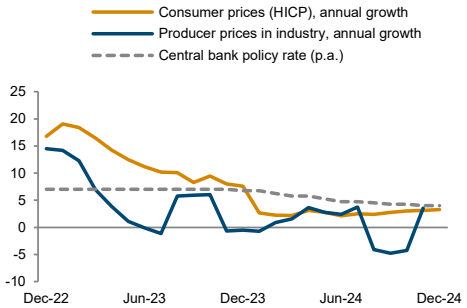
Real sector development
in %



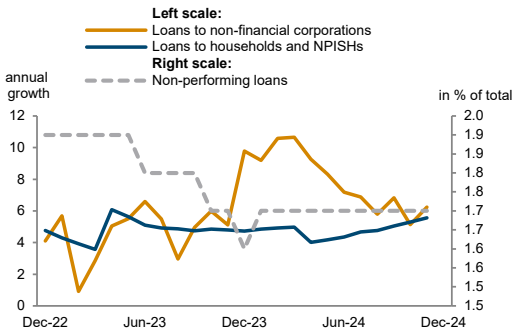
Unit labour costs in industry
annual growth rate in %



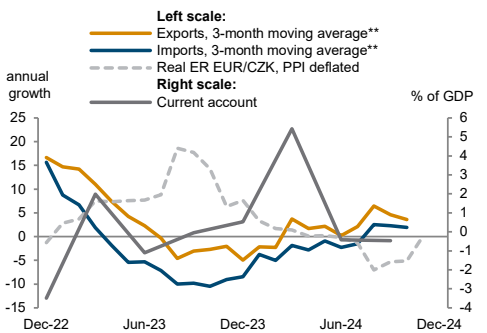
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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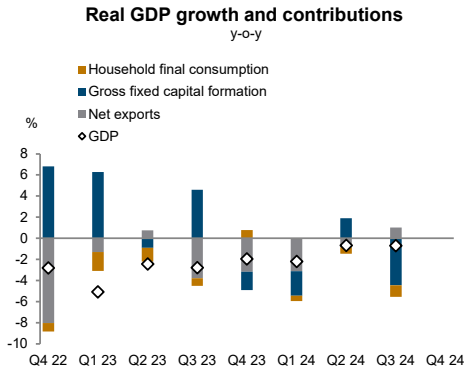
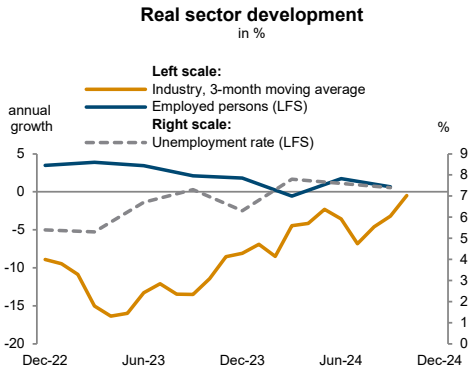
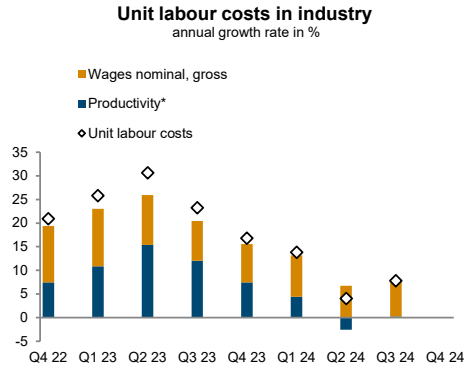
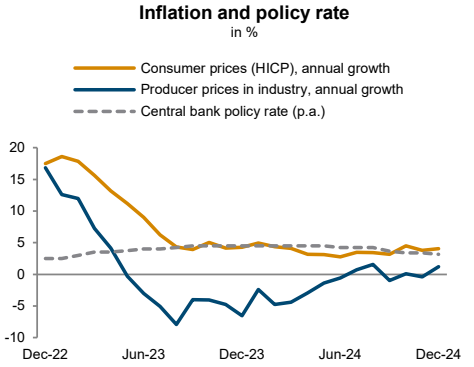
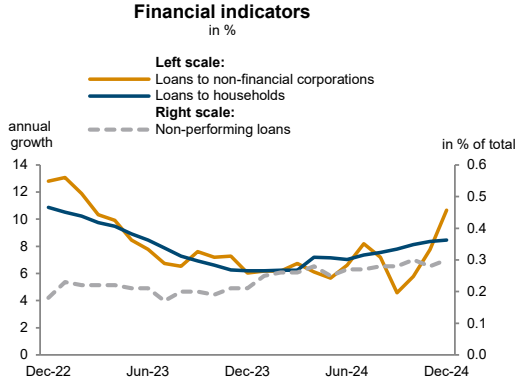
Estonia

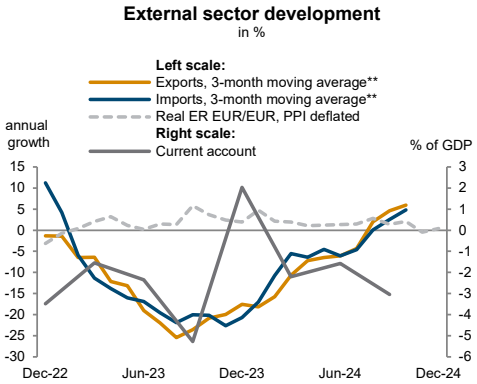












*Positive values of the productivity component on the graph reflect decline in productivity and vice versa.
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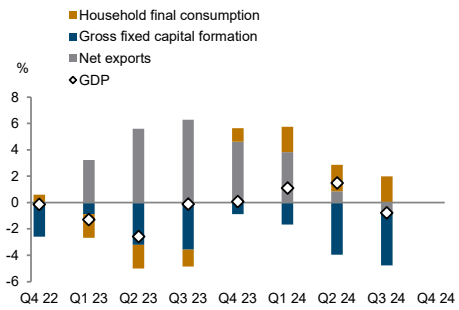
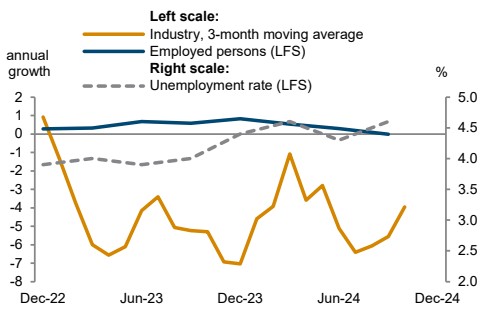
Hungary

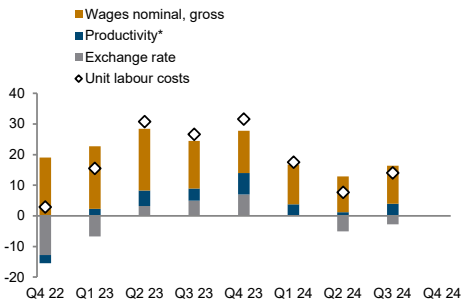
Real GDP growth and contributions
y-o-y



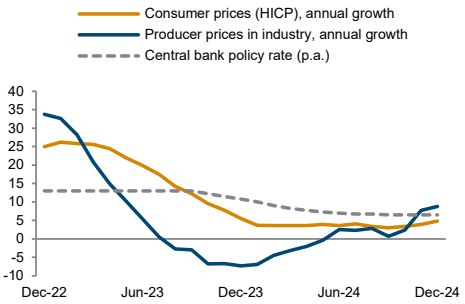
Real sector development
in %



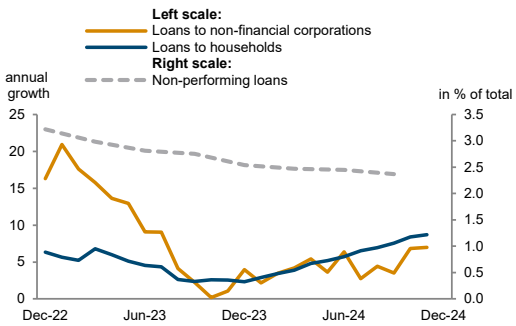
Unit labour costs in industry
annual growth rate in %



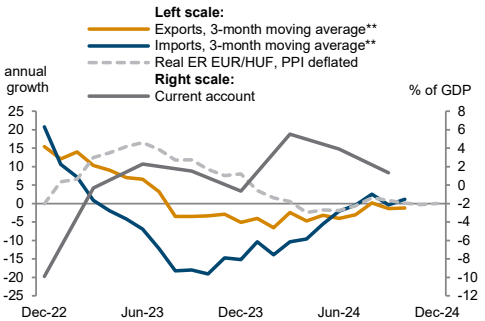
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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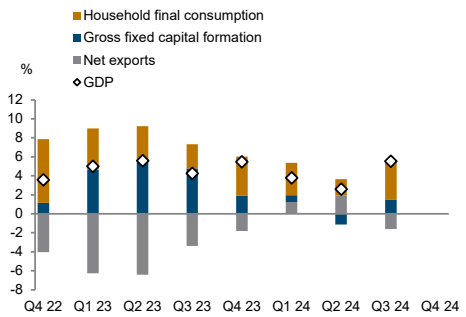
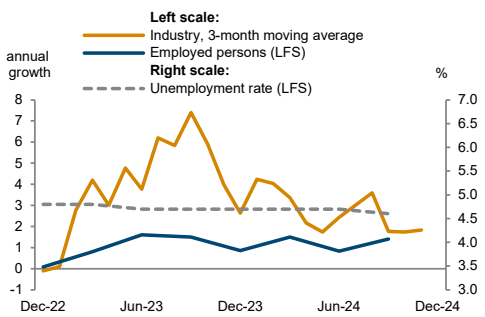
Kazakhstan

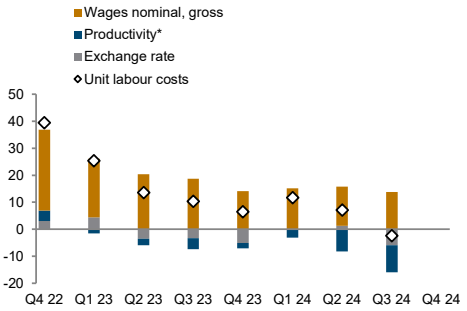
Real GDP growth and contributions
y-o-y



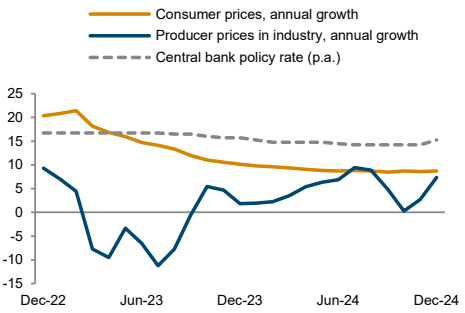
Real sector development
in %



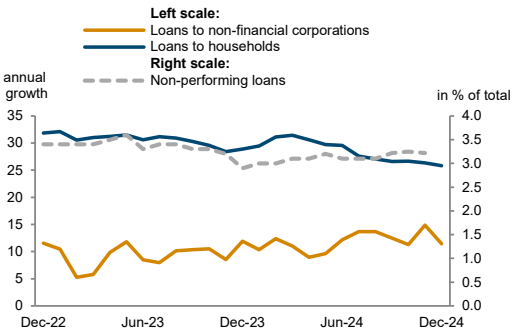
Unit labour costs in industry
annual growth rate in %



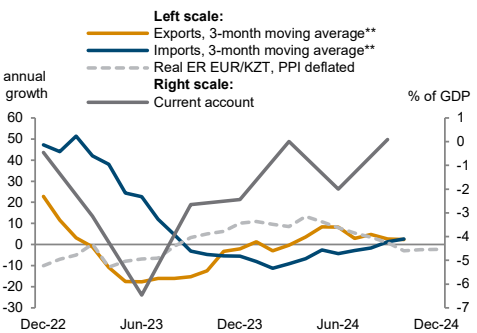
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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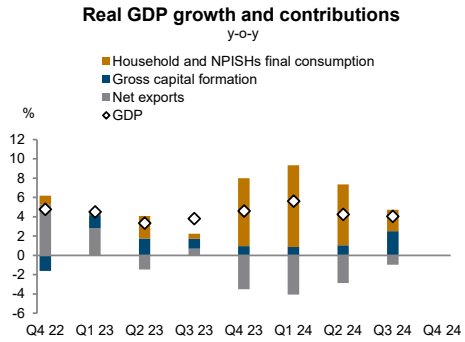
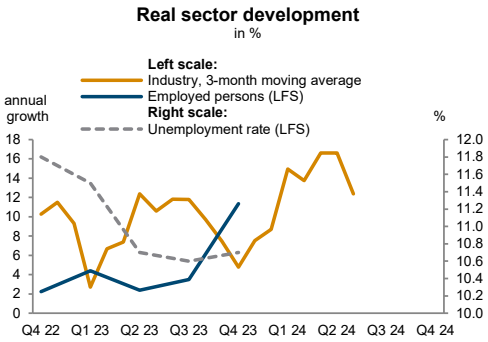
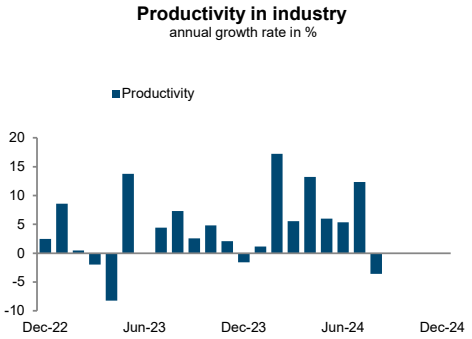
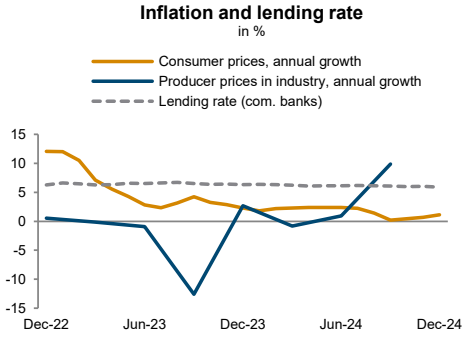
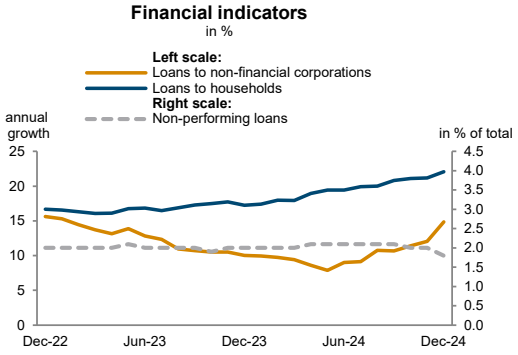
Kosovo

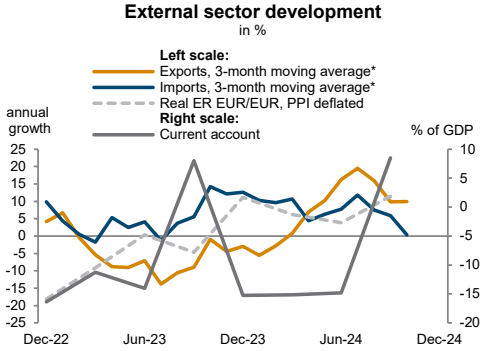












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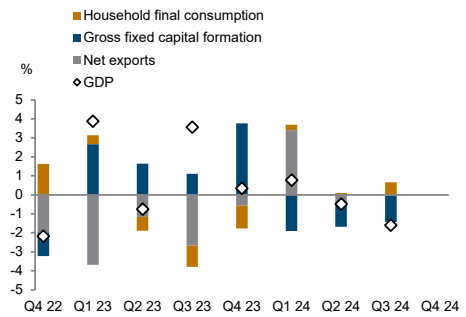
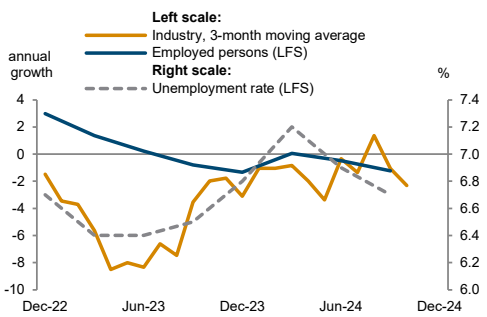
Latvia

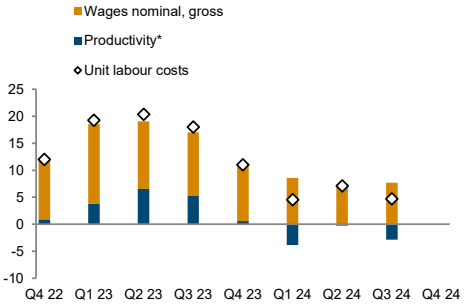
Real GDP growth and contributions
y-o-y



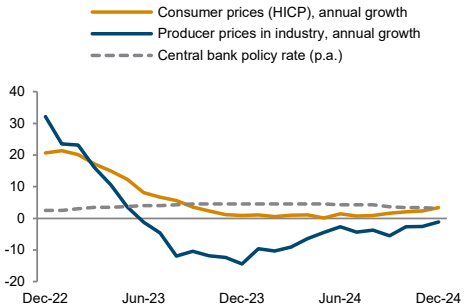
Real sector development
in %



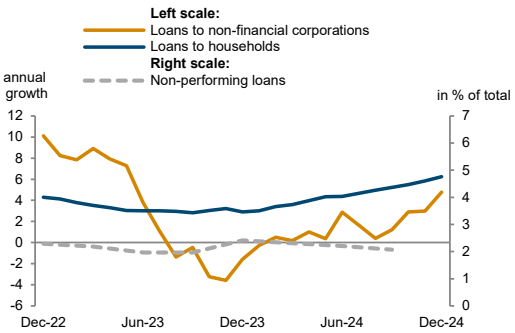
Unit labour costs in industry
annual growth rate in %



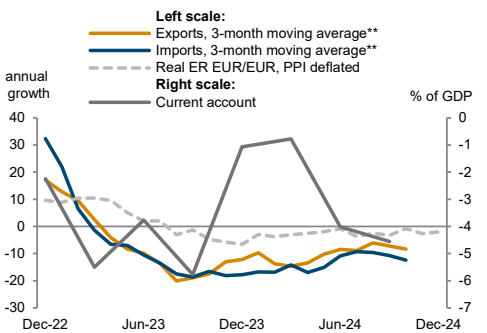
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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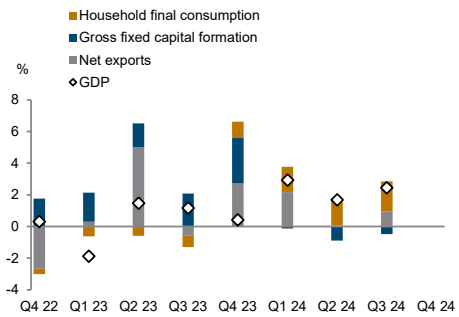
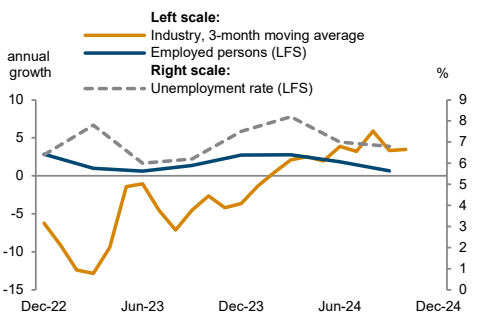
Lithuania

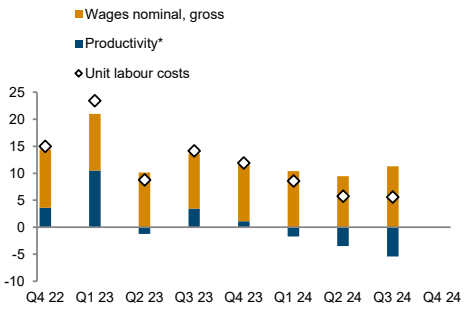
Real GDP growth and contributions
y-o-y



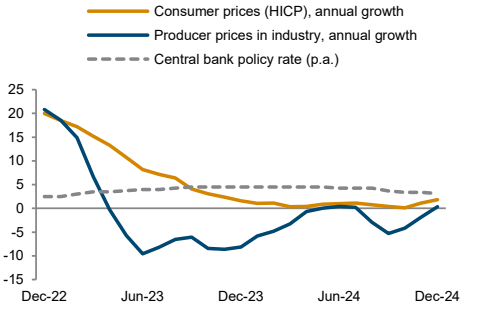
Real sector development
in %



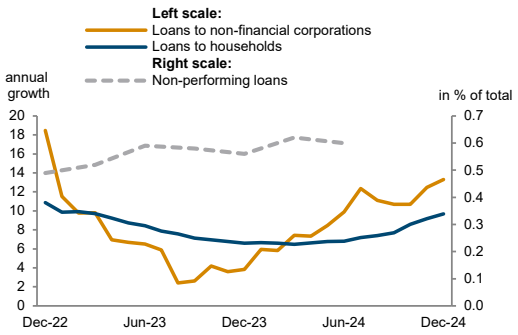
Unit labour costs in industry
annual growth rate in %



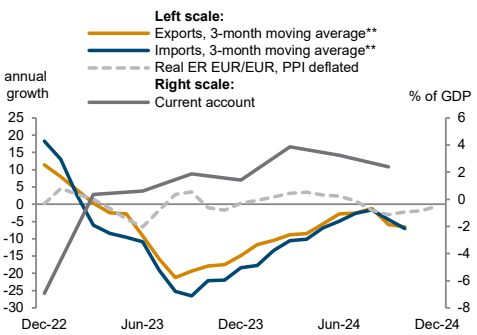
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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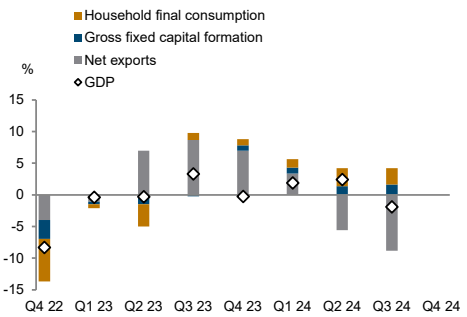
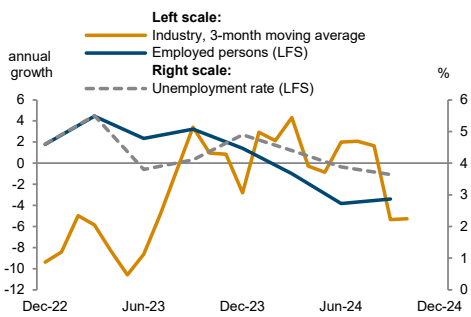
Moldova

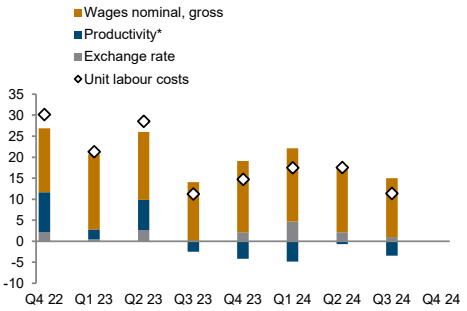
Real GDP growth and contributions
y-o-y



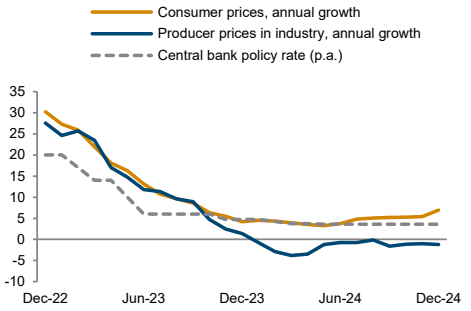
Real sector development
in %



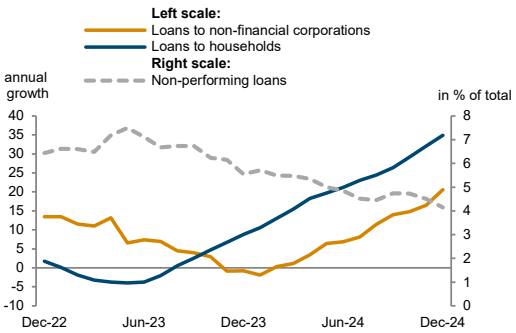
Unit labour costs in industry
annual growth rate in %



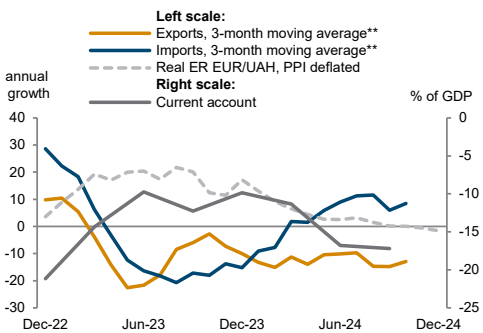
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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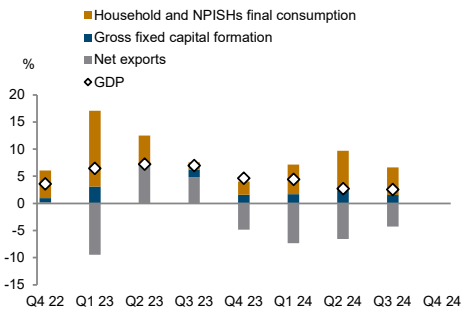
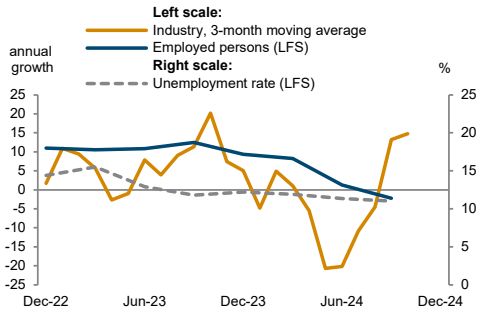
Montenegro

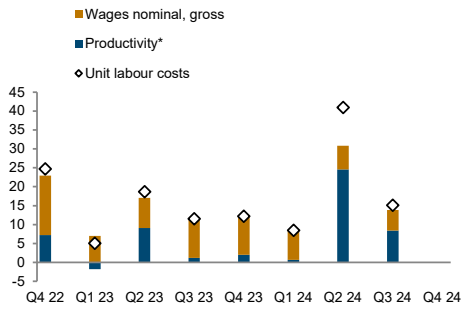
Real GDP growth and contributions
y-o-y



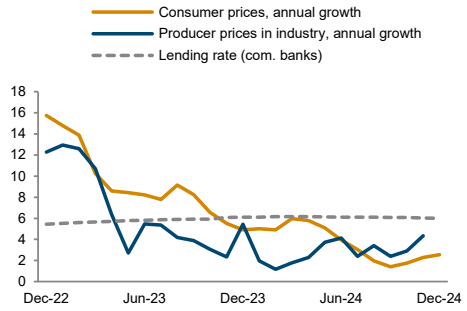
Real sector development
in %



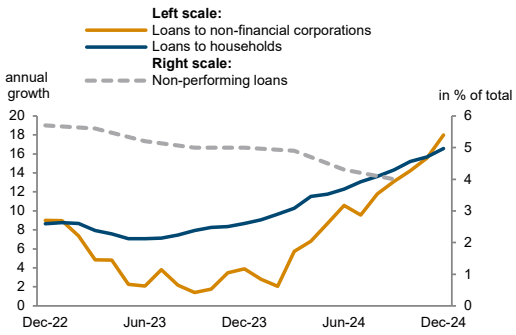
Unit labour costs in industry
annual growth rate in %



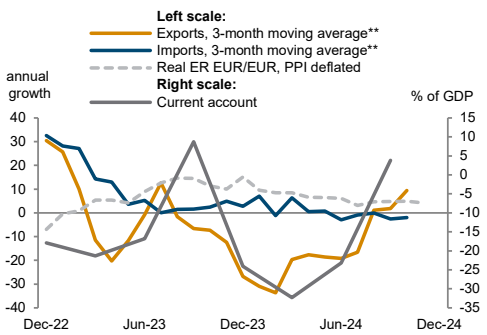
Inflation and lending rate
in %



Financial indicators
in %



External sector development
in %



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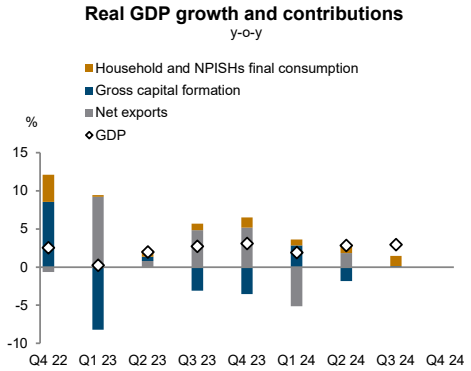
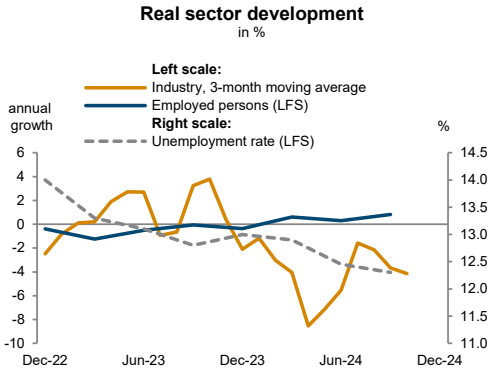
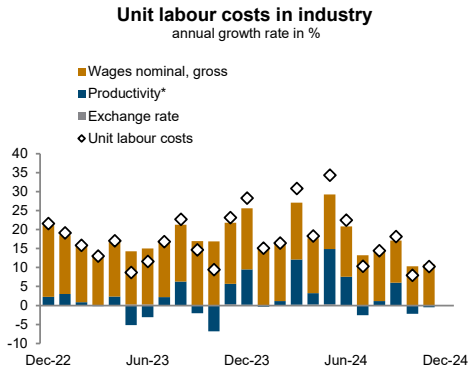
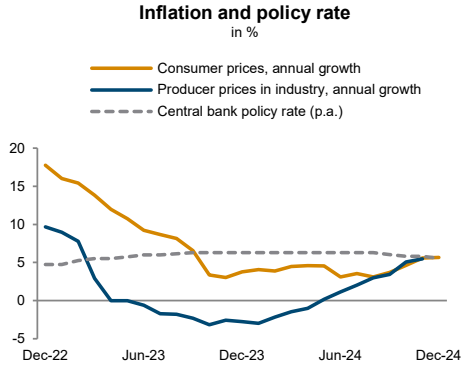
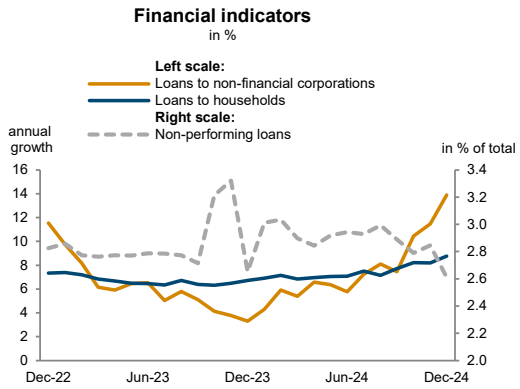
North Macedonia

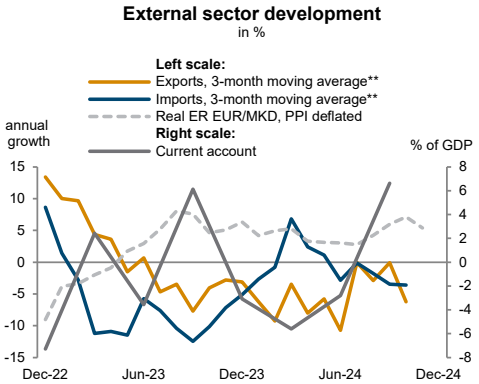












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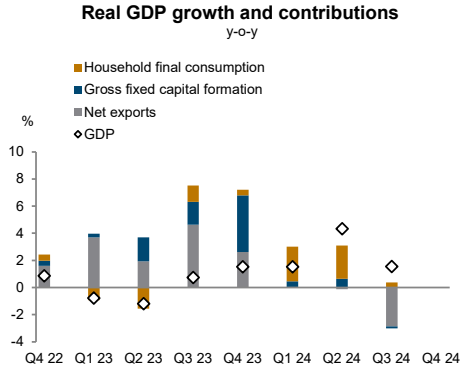
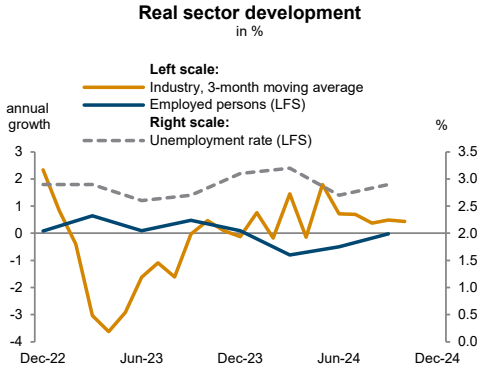
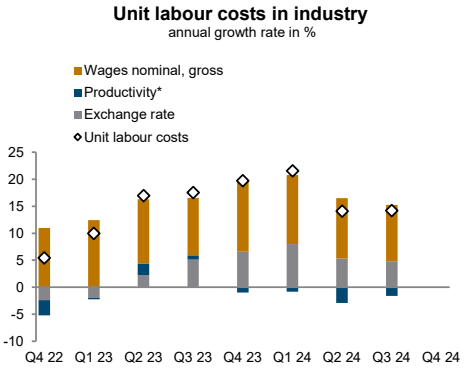
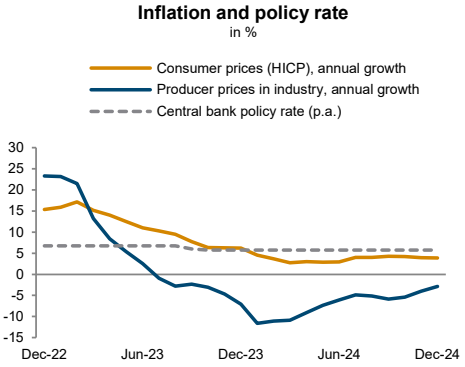
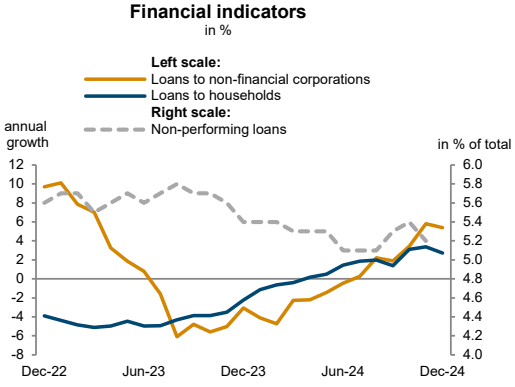
Poland

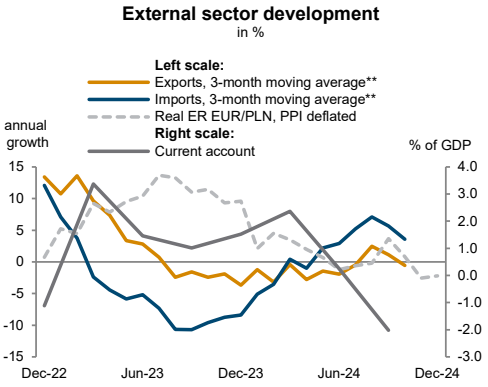












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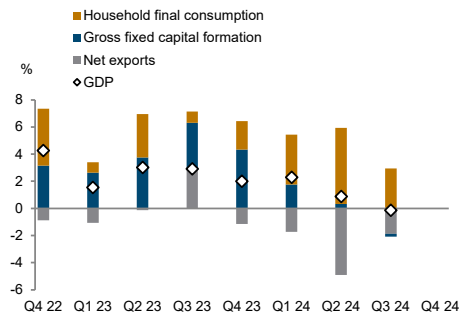
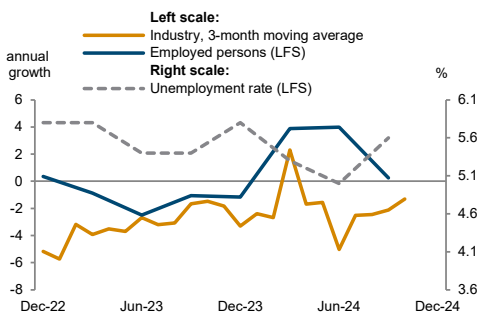
Romania

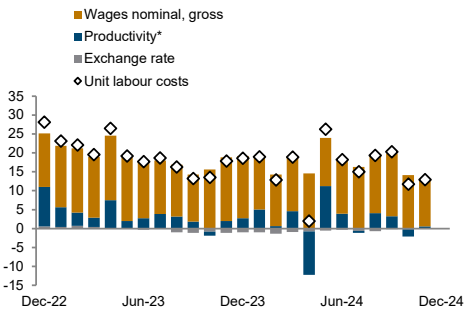
Real GDP growth and contributions
y-o-y



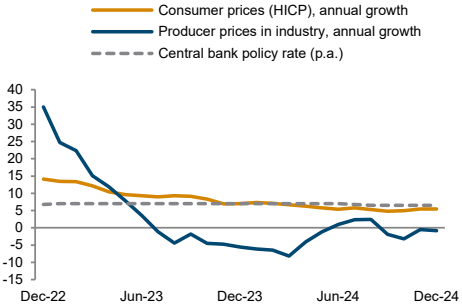
Real sector development
in %



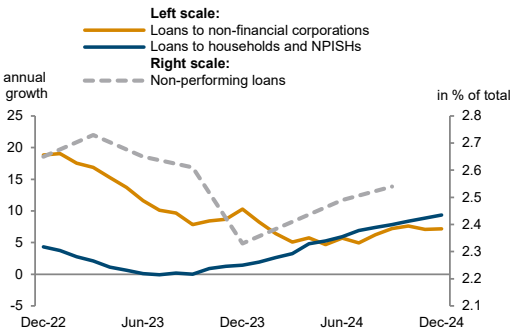
Unit labour costs in industry
annual growth rate in %



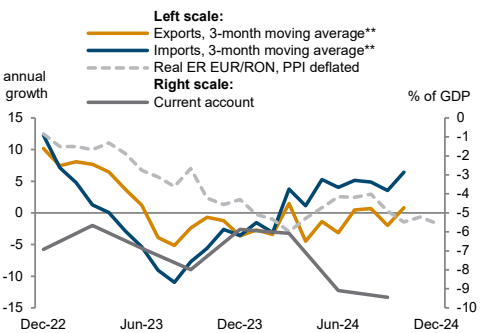
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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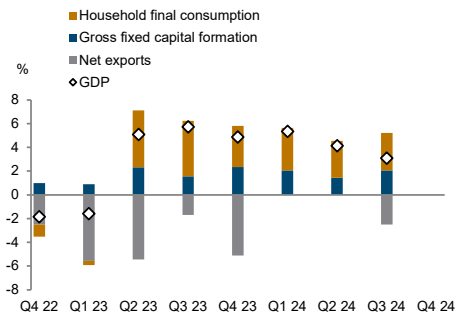
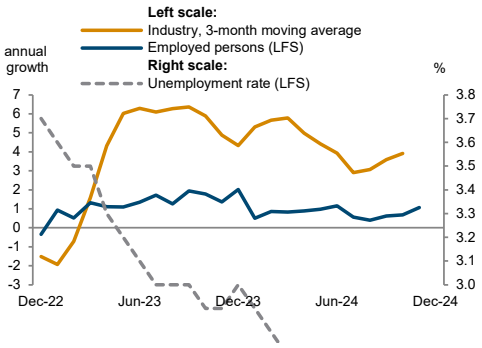
Russia

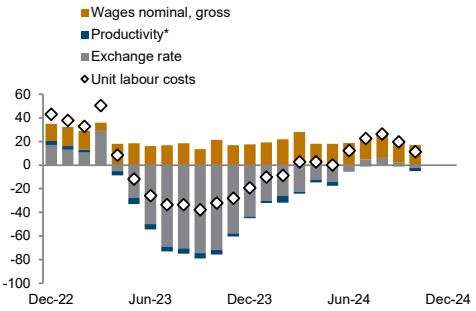
Real GDP growth and contributions
y-o-y



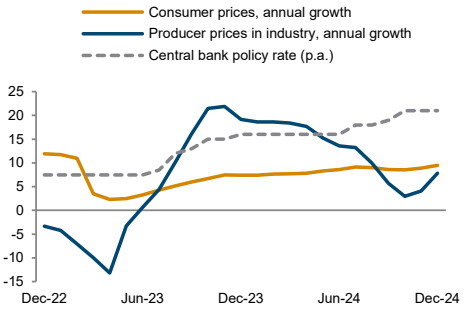
Real sector development
in %



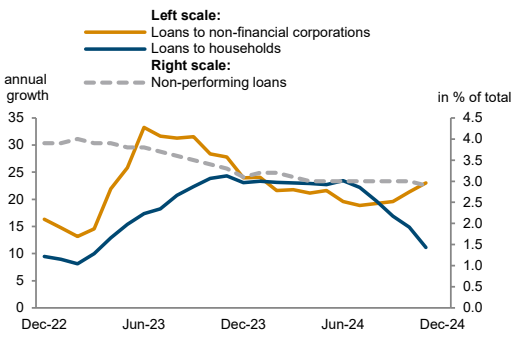
Unit labour costs in industry
annual growth rate in %



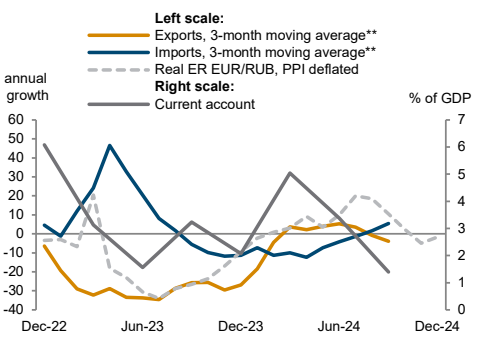
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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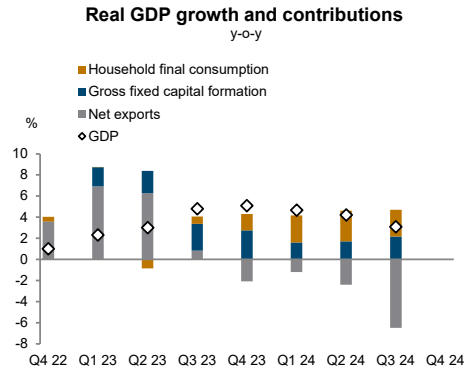
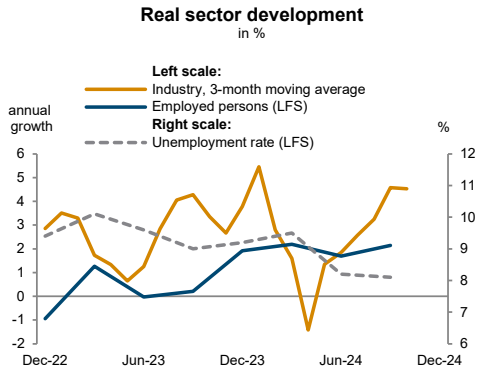
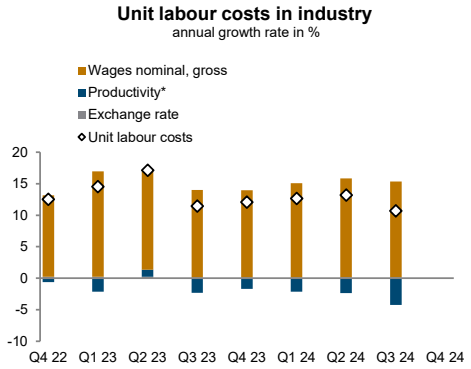
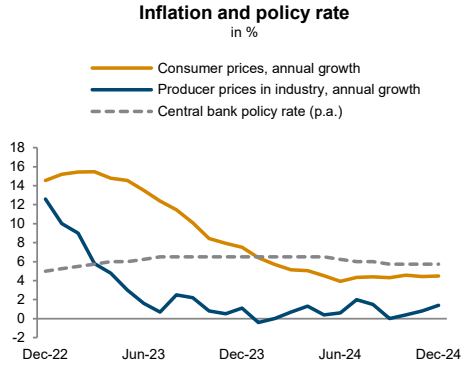
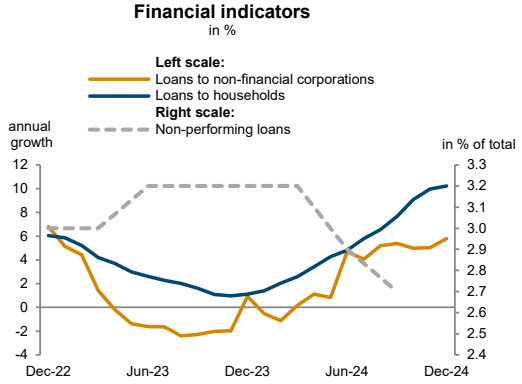
Serbia

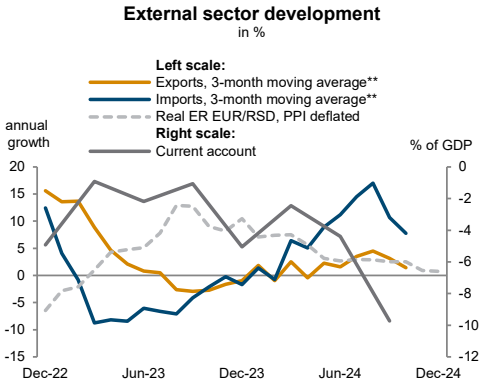












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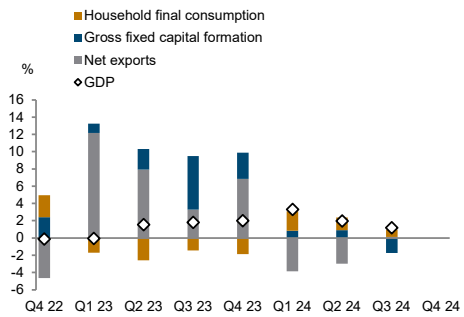
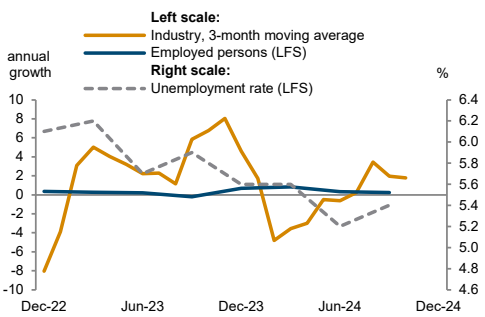
Slovakia

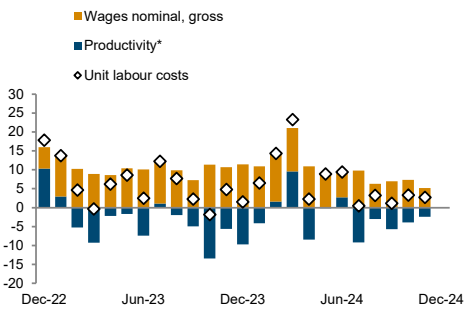
Real GDP growth and contributions
y-o-y



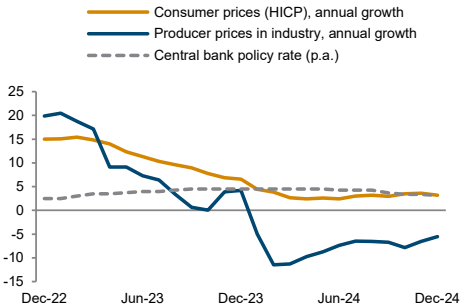
Real sector development
in %



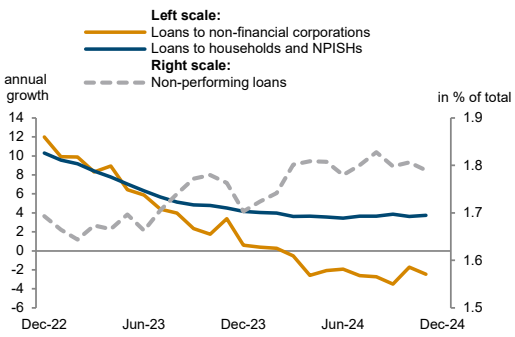
Unit labour costs in industry
annual growth rate in %



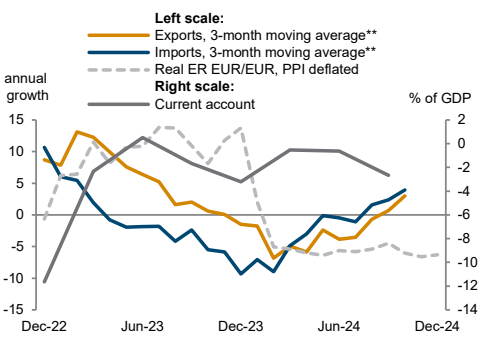
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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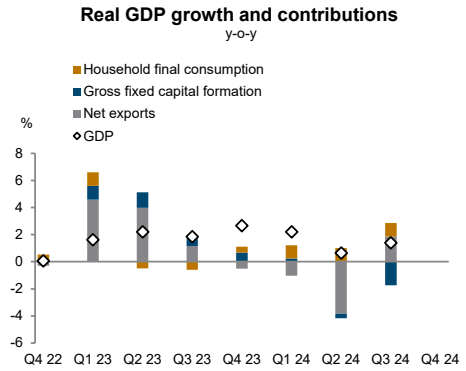
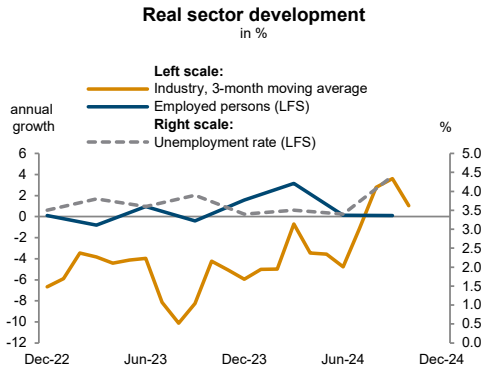
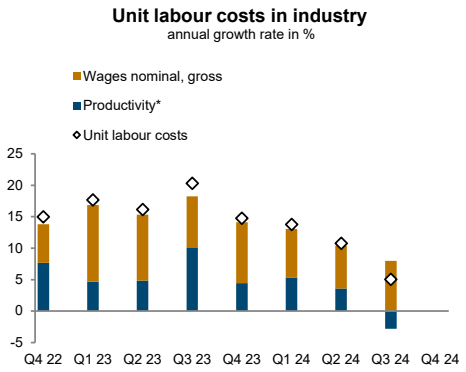
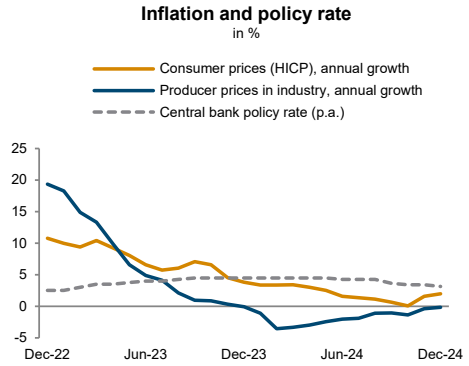
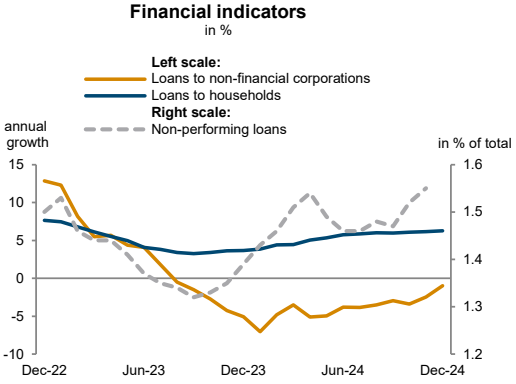
Slovenia

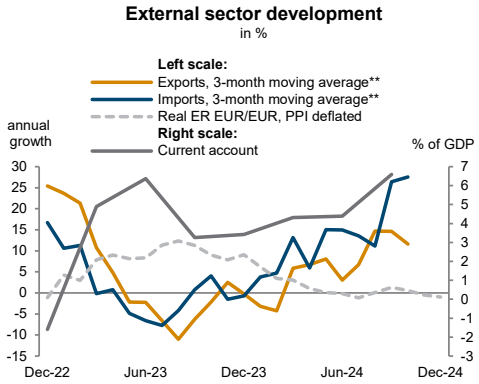












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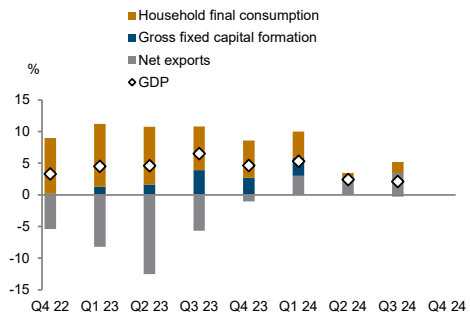
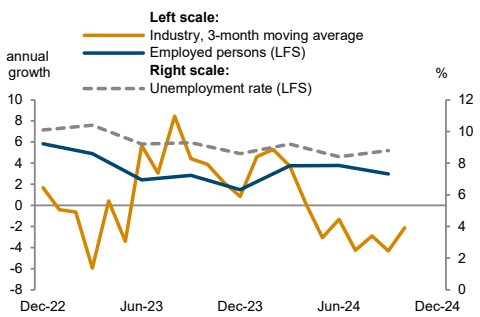
Turkey

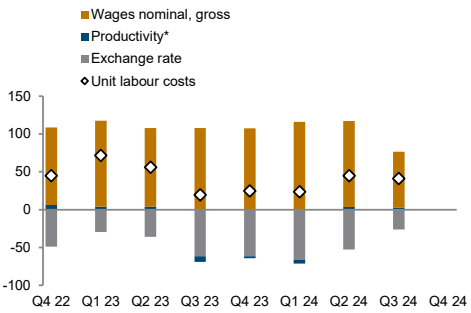
Real GDP growth and contributions
y-o-y



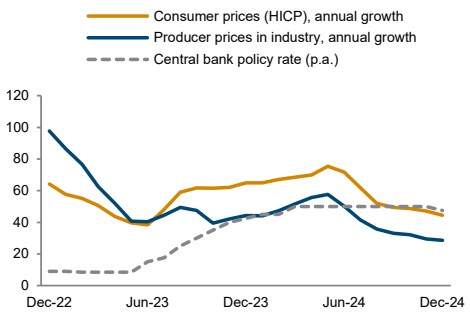
Real sector development
in %



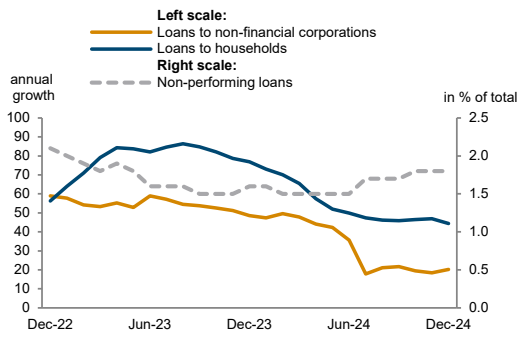
Unit labour costs in industry
annual growth rate in %



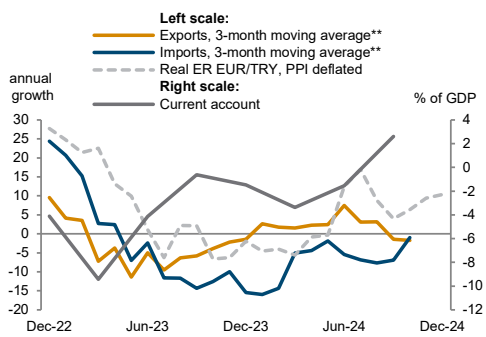
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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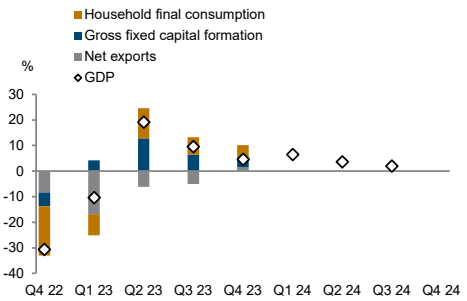
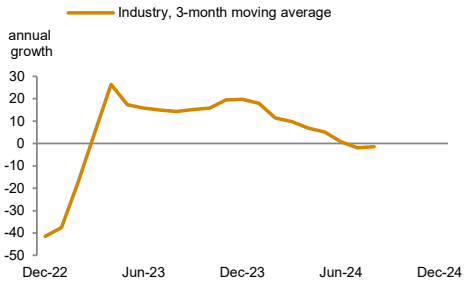
Ukraine

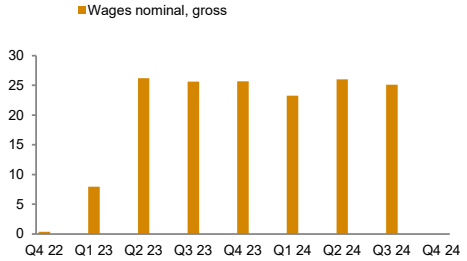
Real GDP growth and contributions
y-o-y



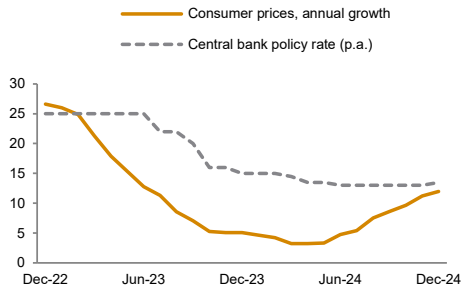
Real sector development
in %



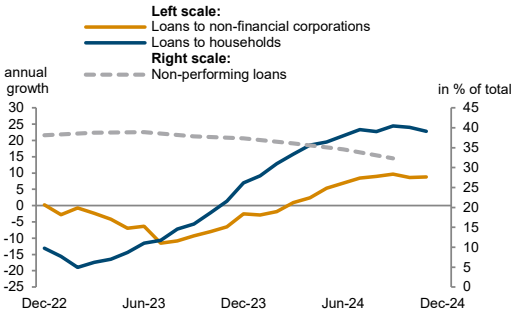
Wages in industry
annual growth rate in %



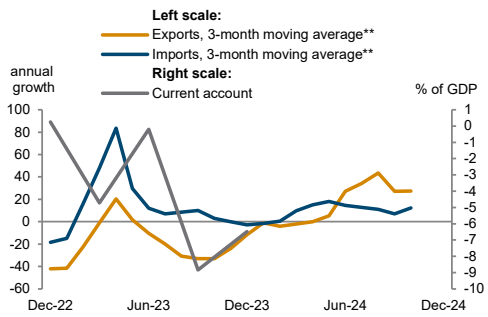
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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multi-country articles and statistical overviews

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