A trade war is no reason to ease monetary policy

By Jeffrey Frankel

November 26, 2018 – *Project Syndicate*

A trade war is a negative supply shock, and central banks cannot counteract the negative effects of current policies on real incomes in the United States, the United Kingdom, and many other countries. Only voters can do that.

The world is in a trade war, and there is no sign of peace breaking out anytime soon. By now, the disruption to trade appears extensive enough to factor negatively into forecasts for economic growth. Does that mean the Federal Reserve should stop gradually raising interest rates?

The answer is no. Monetary policy cannot mitigate the damage done by foolish trade policies.

The biggest trade conflict is between the US and China. In January, the US is scheduled to raise recently imposed tariffs from 10% to 25% on Chinese imports worth $250 billion. President Donald Trump has also threatened to impose new tariffs on the rest of Chinese imports, worth $267 billion. He will meet with Chinese leader Xi Jinping at this week's G20 summit in Buenos Aires. Some hope that the two leaders will achieve a major breakthrough in the trade impasse. But that seems unlikely, partly because the US demands are either beyond China's capacity to deliver (such as a substantial reduction in the bilateral imbalance) or are too fuzzy to be verifiable in the short term (such as ending forced technology transfer).

It is a truism among the economically literate that there are no winners in a trade war. But it is also true that even relatively large statistical effects for individual economic sectors tend to have a relatively small impact on quarterly GDP, at least in the short run. The discrepancy partly reflects the dominant share of services in modern advanced economies, relative to manufacturing and agriculture.

As the trade war broadens and deepens, however, economic-growth forecasts around the world are darkening. The OECD just became the latest international agency to downgrade its global growth forecast, from 3.7% to 3.5% in 2019 and 2020.

The trade war appears to be among the reasons for a renewed slowdown in China. The Chinese slowdown, in turn, will have spillover effects on other countries, especially commodity exporters.

The European economy has also slowed in 2018, with Germany even reporting a surprising contraction in the third quarter. Trade is among the reasons: reduced demand from China, unprecedented uncertainty about US trade policy, and the looming prospect of a "hard" Brexit in which the United Kingdom leaves the European single market and customs union.

Of course, trade is just one of many factors driving economic growth, which has been strong in the US this year, largely owing to late-cycle fiscal stimulus. But the effect of the tax cuts and spending increases implemented since December 2017 is expected to fade soon. The forecasts show US growth slowing from 2.9 % in 2018 to 2.1 % in 2020.

Not everyone agrees that protectionism is bad for the economy. If one focuses on net exports, following Keynesian or even mercantilist arguments, might one not expect to find that Trump's tariffs stimulate US economic growth, with others' losses being America's gains?

The experience of the last year indicates the opposite. If anything, Trump's protectionism is

hurting the US trade balance (when one includes the effects of his administration's fiscal policies). The monthly US trade deficit reached $54 billion in September, exceeding in nominal terms the deficits recorded every month from 2009 to 2017. The tariffs are presumably having a negative effect on US imports, but negative effects on US exports are also large.

This was predictable. When income growth among trading partners slows, they buy less from the US. Moreover, China and other countries have retaliated against US goods with tariffs of their own. Meanwhile, because of the rapidly rising US budget deficit – a remarkable development in a country at full employment – an excess of spending power has spilled over into imports. And the dollar has appreciated against most currencies, undercutting US exporters' competitiveness, again in line with theory.

But while some commentatorsseem to presume that slower growth calls for monetary easing, protectionist measures also increase prices, which has the opposite implication for monetary policy. True, the effect on inflation has been small so far. But there is more to come. Goldman Sachs forecasts a base case (with the 10% tariff on the rest of Chinese imports taking effect early in the second quarter of 2019) in which the impact on US core inflation reaches 0.17% by June. If Trump follows through on his threats to impose tariffs on all car imports and to apply the 25% tariffs to all imports from China, the impact on US core inflation (which strips out food and energy prices) is to reach 0.3% by September 2019.

Adverse trade developments are a negative supply shock. Skillful monetary policy can help offset a negative demand shock, but can do little or nothing to offset a supply shock. Slower growth and higher prices are inevitable effects. The Fed understands that if it were to apply monetary stimulus in an effort to prolong the current expansion artificially (as Trump has pressured it to do), the result would be to fuel inflation.

Trade is not the biggest factor in the US economy. But it is dominant in the United Kingdom these days. Many believe that Brexit's feared negative effect on UK growth has not yet materialized, partly because the Bank of England eased monetary policy. But it is also because the supply shock did not hit when the 2016 vote took place. Arguably, the only impact so far has been on demand (owing, for example, to lower investment in anticipation of the coming rupture). Such a fall in demand is something that monetary policy *can* offset.

Next time could be much worse. Britain's actual exit from the EU is set for March 2019. Perhaps the UK and the EU will conclude a deal, or, better (though less likely), hold another referendum and call the whole thing off. But if Britain "crashes out" of the EU in March, with no arrangements to preserve open trade across the British Channel, monetary policy cannot shore up GDP, as Governor Mark Carney recently warned.

Current trade policies are working to reduce real incomes in the US, Britain, and many other countries. But monetary policy cannot counteract the effects. Only voters can do that.

Jeffrey Frankel, a professor at Harvard University's Kennedy School of Government, previously served as a member of President Bill Clinton's Council of Economic Advisers.