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Fed policy in a trade war

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- Trade wars are negative-sum games – why should it be different under Donald Trump? As they unfold higher import prices are likely to create additional inflation pressures, before declining trade dampens economic activity.

- Monetary policy is likely to become more restrictive in the short- to medium-term. When the trade war takes its toll, this will be reversed.

Both in his testimony to the US Senate on July 17 and in a recent interview on Marketplace, Federal Reserve President Jerome Powell struck a confident tone about the shape of the US economy. In his interview, he emphasized that "*the economy's in a really good place (...) unemployment is now 4 percent (…) we've seen people coming back into the labor force or not leaving it (…) inflation has very gradually moved up and it's now just touching 2 percent. So we're really close to our target. I wouldn't say we've fully achieved it yet*."[1]

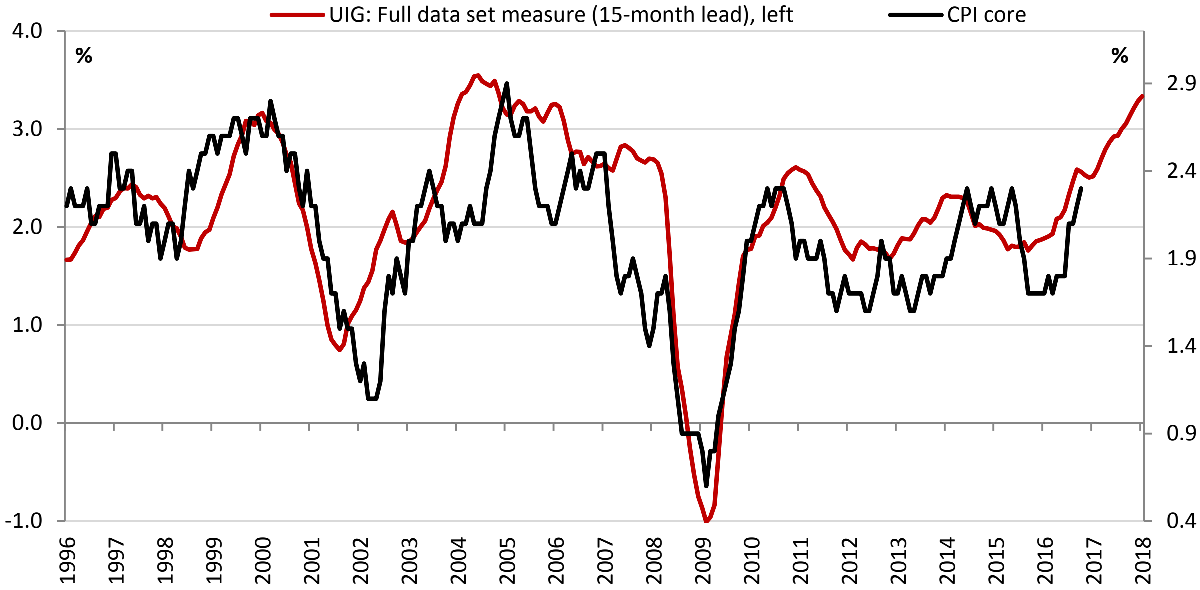
Powell remained vague on trade issues, given that "*[a]gain, we don't know. It's very hard to (…) say which way that's going.*" That said, he then predicted that *"(…) in the near term, (…) the tax reform (…) and the spending increases are very likely (…) to support economic activity here in the United States for at least the next three years."*[2]

For now, the data speak loudly in favor of this upbeat view on the US economy. Specifically, the so called Underlying Inflation Gauge (UIG) of the New York Fed, which aims at offering a broader assessment of the trend inflation than

[1] Interview with Jerome Powell on Marketplace from July 12, 2018, available at: https://www.marketplace.org/2018/07/12/economy/powell-transcript

[2] Both citations are taken from the interview on Marketplace, but Powell broadly confirmed these views in his testimony.

Figure 1. Underlying Inflation Gauge (UIG) in the USA



Source: Federal Reserve Bank of New York

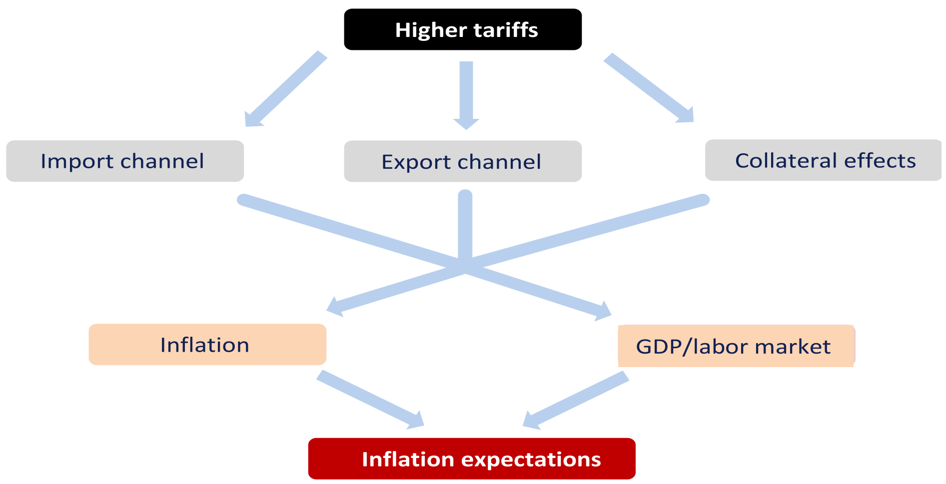
the core CPI index does, suggests that at least in the coming fifteen months inflation could further strengthen, overshooting by almost one percentage point the Fed's inflation target (**Figure 1**).

The measure is likely to currently reflect the positive momentum created by the recent tax reform. The potential effects of recent trade policy measures are yet to materialize.

Economic effects of trade protection

Figure 2 shows three main channels through which trade protection impacts the economy.

Figure 2. Economic effects of a trade war



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In the case of import tariffs on final consumption goods, prices of imported goods increase. If, as a result, consumers divert part of their consumption towards domestic production, GDP could rise, reinforcing the increase on prices.

If tariffs are levied on imported intermediate goods, domestically produced consumer goods also become more expensive. GDP could be lifted if imported inputs could be substituted against domestically produced inputs.

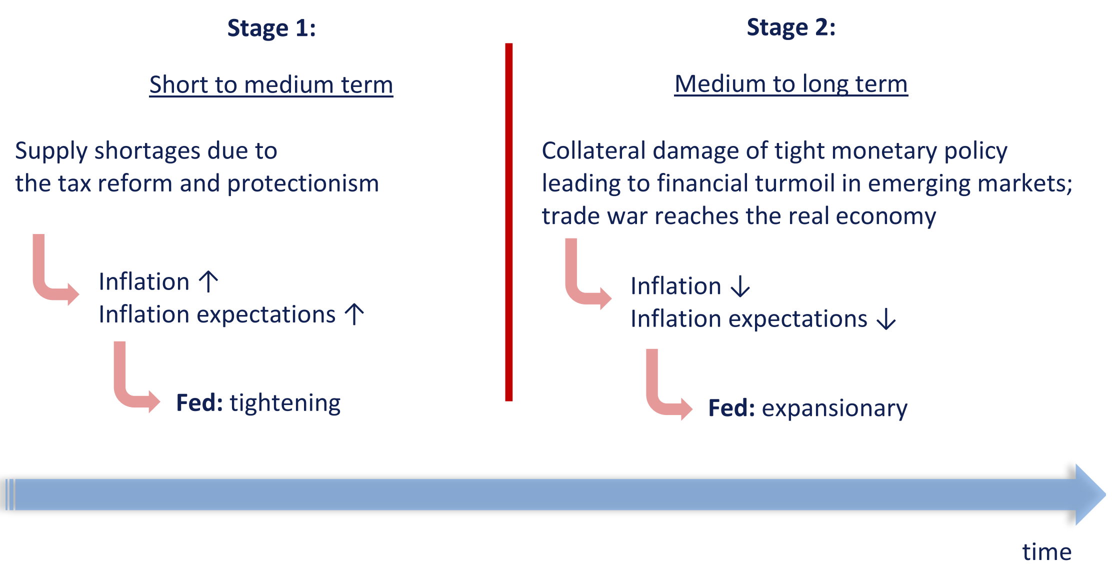
Tariffs have been levied so far both on imports of final consumption goods (like food and washers) and on intermediates (steel and aluminum). Thus increases in prices on imported as well as domestically produced consumer goods could gain momentum. To the extent that substitution is possible, there could even be a temporary increase in domestic production.

In the medium to longer term, however, higher costs for consumer goods are likely to lead to a decline in aggregate demand and GDP. The contractionary effects could be reinforced by a decline in exports, if trading partner countries raised their trade barriers in retaliation, and by lower investment due to growing trade uncertainties.

Reaction of the Fed

The sequence of price and economic effects could lead first to a contraction of monetary policy, followed by a later expansion, when lower growth lowers inflationary pressures (**Figure 3**). Theoretically the Fed could "look through" the effects of protection and keep monetary policy unchanged or even ease in anticipation of later damage. In our view, however, this is unlikely, because both the evolution of trade policy in the US and abroad and the economic effects of the measures taken are too complex for an assessment of the eventual result. Hence, we expect the Fed to "feel its way forward".

Figure 3. Implications for Fed's monetary policy



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