Outlook for Fed: Cloudy with chance of trade war

Reuters Staff

* Trump’s tariffs announcement poses headache for Fed

* Markets still betting on U.S. interest rate hike in March

By Howard Schneider and Ann Saphir - March 2, 2018

WASHINGTON, March 2 (Reuters) - The Federal Reserve digested the Trump administration’s massive tax cuts and plan to boost spending with barely a hiccup, but Washington’s sudden push for steep tariffs on steel and aluminum imports could saddle the U.S. central bank with the worst of both worlds - rising inflation and a slowing global economy.

The combination of fiscal stimulus, which Fed officials viewed as hardly a game-changer for monetary policy, and a brewing trade war is a recipe for the sort of no-win situation central bankers faced in the 1970s when they had to stomach high inflation or run the risk that interest rate increases would trigger a recession.

The tariffs that President Donald Trump said he plans to levy next week, and the global reaction to the announcement, punctured what had been a fairly calm and even bullish picture of the U.S. economy outlined by Fed Chairman Jerome Powell during testimony in Congress this week.

The central bank will now have to factor in the macroeconomic impact of the tariffs, which is expected to be small in itself, but also the broader risk of global retaliation, government-imposed price pressures on a variety of goods, and an ebbing of world trade.

Canada, Brazil and the European Union have already threatened countermeasures, representing what economists refer to as a“deadweight loss” to global welfare. The International Monetary Fund on Friday said Trump’s move likely would damage the U.S. economy as well as the economies of other nations.

“What you have to worry about is that this starts governments globally down the path of protectionism and trade wars,” said Ward McCarthy, chief economist at investment bank Jefferies.“If that’s where this goes, it’s very bad for economic growth ... It would really complicate and confuse the picture.”

Much is uncertain. The tariffs - 25 percent on steel and 10 percent on aluminum - have not been imposed, though Trump has promised that they will be.

That was enough to send U.S. stocks reeling on Thursday and early on Friday. They recovered some losses on Friday afternoon, but the Dow Jones Industrial Average was still down about 2.5 percent over the two days while the broader S&P 500 index had shed about 1.6 percent.

RIPPLE EFFECTS

It is not known how broad a set of countries the tariffs would reach, or how dramatically those countries might react.

Though the White House seemed initially dismissive of the risks, with Trump tweeting on Friday that “Trade wars are good, and easy to win,” the tariffs could undermine some of the economic benefits arising from the overhaul of the U.S. tax code late last year.

The primary metals makers and the 373,000 workers in those industries who would most benefit from the tariffs account for a small slice of gross domestic product though they are geographically concentrated in politically important areas.

About 40 percent of those jobs are in five states. Three of them are Ohio, Pennsylvania and Michigan, which formed much of the backbone of Trump’s 2016 election win and are seen as key to Republican fortunes in congressional elections later this year.

The ripple effects, however, will be nationwide.

The profits of corporations that use steel could be dented, causing them to hold back on the investments or wage increases the White House says would flow from lower corporate taxes. In an age when carbon fiber is used on airplane wings and consumer products like bicycles, raising the price of aluminum and steel may boost demand for substitutes or research into alternatives.

How it all shakes out, domestically and globally, is unpredictable, according to economists and other observers.

“Make no mistake, the risk of inflation reaching 4 percent or more is real, and that will force the Fed to act much more aggressively in tightening monetary policy,” said **Bernard Baumohl, chief global economist at the Economic Outlook Group**.

“Given this business cycle is already long in the tooth, these are the kinds of policy blunders that could easily bring this expansion to quick end,” **Baumohl** said.

The Fed may be able to suspend judgment for a while. The central bank is expected to raise interest rates at its policy meeting in March, and following the tariff announcement investors do not seem to have changed their expectations for that to proceed.

But moving past that meeting, should protectionism become the mood of the day, the Fed’s hope for a“soft-landing” era of full employment and on-target inflation may instead become a choice of which bad outcome to tolerate - rising prices or higher unemployment.

“The real worry is that this marks a turning point in U.S. trade policy, away from bluster and brinkmanship towards actual protectionist measures. We have consistently warned that this would become more likely as the mid-term and presidential elections approach,” Andrew Kenningham, chief global economist for Capital Economics, wrote on Friday.“If so, President Trump may discover that, contrary to his tweet this morning, there are rarely any winners from trade wars.”

###