Speech

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Protectionism complicates monetary policy
Volkswirtschaftliche Gesellschaft des Kantons Bern

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Ladies and Gentlemen

Switzerland owes much of the prosperity it enjoys today to open markets and thriving trade with many countries across the globe. In recent decades, free trade in goods and services, coupled with advancing technological progress, has delivered growth and prosperity, not just in Switzerland but in many other parts of the world, too.

Recognising the advantages of international trade, most countries remained true to the principles of free trade even amid the outbreak of the financial crisis almost exactly ten years ago. They resisted the temptation of knee-jerk isolationist responses and refrained from sweeping protectionist measures. The onus was on not repeating the mistakes made in the Great Depression of the 1930s, when such interventions served only to accelerate the economic decline rather than bringing the hoped-for respite. As we now know, and as Chart 1 clearly shows, the consequences were disastrous. Recovery from the Great Depression was painfully slow, whereas world trade returned relatively quickly to its previous levels following the most recent crisis.

Holding firm during the financial crisis has paid off. The economic recovery may have taken some time in many areas, but the global economy is now back in fairly good shape. But it is at this very moment, when a lot of countries are able to post respectable economic growth, that protectionism appears to be rearing its head again. Trade disputes between several countries are jeopardising the global upturn. Burgeoning protectionism also entails considerable challenges for central banks – and thus for the Swiss National Bank (SNB), too – as it brings with it the threat of negative consequences for monetary policy.

Free trade as a scapegoat

Before I come to the actual subject of my speech, namely the relationship between protectionism and monetary policy, I would like, if I may, to take a step back for a moment and look at where the calls for protectionism stem from.

Numerous academic and empirical studies[1] have demonstrated that the free exchange of goods and services improves people's standard of living. The list of positive effects of free trade is long: the division of labour and specialisation allows countries to produce what they are best at relative to their trading partners and import the rest;[2] unrestricted access to foreign markets facilitates more cost-effective production given the larger sales volumes; the availability of a broad array of foreign products increases choice for consumers with regard to end products and for producers with regard to primary and intermediate products; increased competition from foreign rivals promotes efficiency and innovation; the open exchange of goods and services also leads to the spread of knowledge and new technologies, and in so doing contributes to progress and growth as well. As a small open economy, Switzerland is well aware of the benefits of the freest possible trade in goods and services with the rest of the

[1] Cf. Sachs and Warner (1995) as well as Frankel and Romer (1999), for example.

[2] Cf. Ricardo (1817).

world. Chart 2 clearly illustrates the extent to which our country is integrated in the international trading system. Switzerland profits tremendously from its openness.

If the advantages of free trade are so strikingly obvious, then why is there any resistance at all? The answer is relatively simple: because not everyone is profiting from it to the same extent. Although all countries that engage in free trade benefit overall from the unrestricted exchange of goods and services, this is not necessarily the case for every household and every company. Free trade also has its losers. People working in industries that are structurally weak face the risk of losing their jobs if opening up the market means domestic providers are pushed out by more efficient competitors from abroad. The same applies to companies operating in such sectors and their owners, as they can also suffer heavy losses in this scenario. Anyone who sees free trade as a threat to their livelihood is naturally going to reject it, irrespective of the fact that they stand to gain as a consumer and their country as a whole will benefit. While there is now scarcely any debate as to whether free trade leads to greater prosperity overall, the criticism is instead increasingly centred on inequality in the distribution of these prosperity gains.

In phases of rapidly advancing globalisation, the distributional effects are particularly pronounced and apparent. For instance, China's integration in world trade and its subsequent elevation to the leading trading nation is likely to have markedly accelerated the pace of structural change in some countries, negatively impacting on specific industries and sections of the population.[3]

However, the rise of certain companies and sectors, and the decline or even disappearance of others, cannot be put down to international trade alone. The impact of technological progress in driving structural change is at least as strong.[4] Free trade thus often finds itself cast in the role of scapegoat for what is in any case a perpetual process. There is no escaping the reality of this ongoing structural change if a country wants to maintain its competitiveness over the long term.

There have also been increasing calls of late for free trade to be curbed because it is not 'fair' for certain countries. In this context, the concept of 'fairness' is applied in entirely different ways. It is used in assessing bilateral trading relationships, for example, or in connection with alleged violations of existing trade rules. I would like to briefly address both these aspects.

It seems rather odd to insist that trade between two countries can only be regarded as fair if the bilateral balance of trade is in equilibrium. Trade between the actors in these countries is voluntary, and therefore only takes place if all of the participants stand to benefit from the exchange. Such trade is not a zero-sum game in which one side's gain is the other side's loss. The view that the trade balance between two countries should be in equilibrium ignores both the reality of global value chains and also the very essence of specialisation. Today semi-finished products and intermediate inputs can move back and forward across national borders

[3] Cf. Autor et al. (2016), for example.

[4] Cf. World Trade Organization (2017), for example.

many times before the end product is complete. Simply netting bilateral trade flows is no basis for judging whether trade is fair or not. Bilateral trade balances that are not in equilibrium are not a problem per se, and are instead much more an expression of the respective parties focusing on their own strengths. A country's deficit with one trading partner can be financed through its surplus with another.

That said, I do not want to paint too rosy a picture of the current trading system. This brings me to the second facet of the concept of 'fairness'. The accusation that not all countries play by the rules of global trade is not without justification. Chart 3 shows that the number of tariff and non-tariff barriers to trade has increased again of late – with the latter often opaque and thus potentially even more damaging than customs duty. Examples include not taking due account of the principle of reciprocal market access or the protection of intellectual property, or distorting the free exchange of goods and services by way of subsidies. From this perspective, there is a valid point in calling for fairness. After all, international trade is in fact only fair if everyone plays by the rules of the global trading system. I will come back to this point later.

No country wins a trade war

The import duties recently imposed or increased by the US on certain goods have already prompted the first counteractions from the trading partners concerned. Were the spiral of protectionist measures and retaliation to continue, this could develop into an all-out trade war, which would have drastic consequences for the global economy. Protectionism is the polar opposite of free trade, the negative impact of the former mirroring the positive effects of the latter. Tariffs make imports more expensive, thereby increasing domestic production costs and reducing consumers' purchasing power. Tariffs imposed by trading partners restrict exports. Trade barriers impact on the division of labour worldwide, productivity declines, growth and progress are curbed.

Although it is difficult to estimate the negative impact of a worldwide trade dispute on global GDP, there can be no question that a full-scale trade war would weigh heavily on the world economy. Not least because it would be likely to entail a slump in confidence among economic actors and upheaval on the financial markets.[5] All countries would feel the detrimental effect of a global trade war, but small open economies such as Switzerland would be among those hardest hit.

[5] A range of authors have recently published estimates of the effects of a global trade war on the real economy. In their study, Berthou et al. (2018) simulate a 10 percentage point increase in tariffs worldwide, and found that this could reduce global GDP by around 1% after two years, taking only the direct trading effects into account. Other studies, such as that published by the OECD (2016), show similar results. If the indirect effects on confidence and the financial markets are considered in addition to the direct impact, the decrease in global GDP could be three times greater (Berthou et al., 2018). Other institutions, such as the International Monetary Fund (July 2018) and the Bank for International Settlements (Carstens, 2018), highlight the significance of indirect impacts, too.

Protectionism as a source of uncertainty for monetary policy

The SNB’s monetary policy would also be affected by such a development – and this brings me to the main part of my speech. Over the short term, tariffs and other trade barriers have an inflationary impact and curb growth. We economists talk of a negative supply shock, or in other words an abrupt increase in production costs. The oil price shock of 1973 is a textbook example of this. Back then, a supply embargo imposed by the Arab members of the Organization of the Petroleum Exporting Countries (OPEC) saw the price of oil treble within a very short period of time. Given that oil was at that time an even more important raw material in the production of goods than it is today, this resulted in a sharp rise in consumer price inflation and a slump in GDP growth. Chart 4 illustrates this using the example of the US. A global rise in tariffs would have a similar effect.

What the optimal monetary policy response for a central bank is in the case of a negative supply shock is not immediately obvious. This also applies to an abrupt and hefty rise in tariffs. Should a central bank raise interest rates in such a situation to combat inflation, or should it lower rates to stimulate economic activity? The specific monetary policy response adopted depends on a number of factors, some being immediately relevant for monetary policy, others only in the long term.

As soon as new tariffs are announced, the question arises as to whether they are temporary or permanent, or whether they could even lead to a raft of protectionist measures. One-off increases in duties that are merely temporary in nature will similarly take only a temporary toll on the economy, and thus do not necessarily require any monetary policy reaction.

What is significant in this context is the expectations of producers and consumers. Longer-term inflation expectations in particular are of pivotal importance for the monetary policy stance. Central banks have to respond differently depending on how economic actors adjust their expectations to take account of the higher tariffs. If inflation expectations are well anchored, that is to say very stable, central banks can choose to ignore temporarily higher inflation, and can thus concentrate fully on the negative growth effects triggered by protectionism. After all, if inflation expectations are well anchored, higher prices should not lead to a damaging wage-price spiral. Inflation would come back down again sooner or later. However, if consumers and producers expect the trade war to result in steadily rising prices, this would fuel upward inflationary pressure over the long term. In this case, monetary policy would have to be tightened to address the higher inflation expectations.

The way in which exchange rates react to higher tariffs worldwide is also highly dependent on the expectations of economic actors. Exchange rates are typically hard to forecast, and all the more so in the scenario of a global trade war. For the Swiss franc, which is traditionally seen as a safe haven, the risk assessment of investors would be particularly important. Would our currency be sought as a safe haven in the event of a trade war? Or would it even come under downward pressure given that Switzerland, as a small open economy, would face particularly strong exposure to a severe contraction in world trade? Chart 5 shows that the marked increase in uncertainty relating to trade policy has so far not had any lasting influence on the

value of the Swiss franc. However, it could be a different picture if there were to be a trade war.

The lessons learned from the Great Depression show that a trade war may be followed by a currency war. If many countries deliberately weaken their currency to support their own export sector, the consequences for the global economy are severe. Being aware of this, central banks have in recent years consistently refrained from engaging in competitive devaluations. However, it is difficult to predict how they would behave in the event of a fully-fledged trade war.

I have mentioned only a few of the factors that are relevant for a central bank's immediate monetary policy response to an upsurge in protectionism. They all demonstrate that an upsurge in protectionism first and foremost fuels uncertainty.

I would now like to address some aspects that a central bank has to consider in such a scenario also when looking to the long term. We can only speculate as to the long-term monetary policy implications of protectionism. That said, in a world that would be clearly less open, it would be impossible to rule out changes in the macroeconomic relationships. This is anything but trivial for central banks. Familiar reaction patterns could change, and common indicators could be rendered meaningless.

For the SNB, the main questions in this context relate to how prices and production would behave in an economy that is more closed off from the outside. Domestic influencing factors could become more important regarding inflationary pressure, with the significance of global factors decreasing. After all, globalisation has a dampening impact on prices in that it exposes domestic companies to international competition.[6] If they were to be shielded from foreign competition, this downward pressure on prices could be expected to ease. Domestic shocks could thus have a more direct impact on inflation, and monetary policy would have to address this.

Another particularly relevant question for the SNB is whether – and to what extent – the channels via which our monetary policy takes effect on the real economy and on prices will be affected if the world becomes less open. In a largely closed economy, the importance of the exchange rate as a transmission mechanism would decline. Conversely, the significance of the interest rate channel would probably increase.

Ultimately, protectionism could also change the long-run equilibrium values, i.e. the levels to which an economy tends over the long term. These play a decisive role in determining the monetary policy stance since they serve as a compass for central banks. Increased uncertainty regarding the growth potential of a more closed off economy could result in misdirected monetary policy. If a central bank's estimate of growth potential on the basis of previous

[6] Empirical evidence that increasing globalisation has made prices less sensitive to domestic demand can be found in International Monetary Fund (2006). Cf. also Bank for International Settlements (2018).

conditions is too high, there is the risk of overly expansionary monetary policy delivering unnecessary stimulus to the economy and generating inflation.

All in all, we can say that a wave of protectionism would create a lot of uncertainty, be it with regard to the short-term development of the real economy and prices, or with regard to the longer-term macroeconomic context. It is true to say that central banks have to constantly contend with structural change in the economy in any case; that is indeed part and parcel of what we do. However, protectionism would additionally complicate monetary policy. The risk of monetary policy mistakes would increase, at least while the economy is in the process of adapting to the changed market conditions.

Rules rather than isolationism

As a small open economy, Switzerland would be hit hard by a trade war. It therefore has a vital interest in strongly opposing protectionist tendencies. The best way it can do so is to set a good example and to be prepared to be even more open to trade. The international community of states can counter protectionism by advocating that weaknesses in the current trading system be remedied. On the one hand, the countries involved must make sure that those losing out on account of free trade are better integrated, thus increasing acceptance for economic openness and international trade. This can be achieved by promoting labour mobility and expanding the opportunities for training and continued professional development. Countries that cushion the blow of the adjustment costs of structural change arising from international trade in this manner tend to have a more positive attitude towards free trade.

On the other hand, it must also be ensured that, within the international trading system, the same rules apply to all participants and are globally adhered to. The rules-based multilateral system represented by the World Trade Organization (WTO) must therefore continue to form the backbone of international trade. The system must be rules-based since only clear rules can ensure a stable, predictable environment and thus institutional security. Hence a multilateral approach is important because this is the only way to ensure all countries play by the same rules, irrespective of their size or economic strength. A trading system such as this creates a level playing field for all participants, which is essential in particular for small countries like Switzerland.

The WTO system of rules is by no means perfect, and its weaknesses must be addressed if international trade is to be generally seen as being ‘fair’ once again. That said, protectionism is definitely not the right way to make trade fairer. Rather, the debate surrounding this issue should be taken as motivation to be all the more resolute in eradicating the shortcomings of the existing system. These become evident particularly when it comes to tackling market-distorting subsidies and hidden market access barriers in many countries. Furthermore, there is also room for improvement with regard to dispute resolution and the monitoring and transparency of WTO members’ trade measures. Finally, it would also make sense to modernise the WTO by placing a stronger focus on the services sector and online trade.

Conclusion

Ladies and Gentlemen, dealing with economic openness is not always easy – and like others, Switzerland repeatedly faces new challenges in this regard. However, our country has learned to deal with them. The necessary flexibility has been and remains entirely conducive to Switzerland's competitiveness. It is almost certainly no coincidence that the most productive sectors in the Swiss economy are those with particularly strong exposure to international competition. The commitment to open markets and the willingness to continually adapt to structural change are pivotal when it comes to securing a country's competitiveness over the long term. Protectionism can only serve to delay structural change in a country, it cannot stop it. It is detrimental to competitiveness and ultimately to prosperity as well.

Central banks cannot directly shape the international trading system, nor can they prevent protectionism. Should the current trade disputes escalate into a fully fledged trade war, the SNB would have to adapt to this new backdrop. The uncertainty that a flare-up in protectionism would bring would nevertheless complicate the fulfilment of our mandate.

Let me make one thing clear: The tariffs that have been imposed in the past few months will not plunge the world into a recession. Any such fears are exaggerated. As Chart 6 shows, the International Monetary Fund, in its recently published outlook, continues to forecast steady growth in global GDP and world trade.[7] Should the protectionist spiral continue, however, this could stall the global expansion phase and fuel inflation.

Switzerland would be well advised to actively advocate appropriate trade rules at the international level, and ensure that these are kept to in spirit and not just by the letter. Free trade is one of the key driving forces behind our prosperity, and we should do our utmost to safeguard its achievements.

[7] Cf. International Monetary Fund (October 2018).

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SCHWEIZERISCHE NATIONALBANK
BANQUE NATIONALE SUISSE
BANCA NAZIONALE SVIZZERA
BANCA NAZIUNALA SVIZRA
SWISS NATIONAL BANK

Chart 1

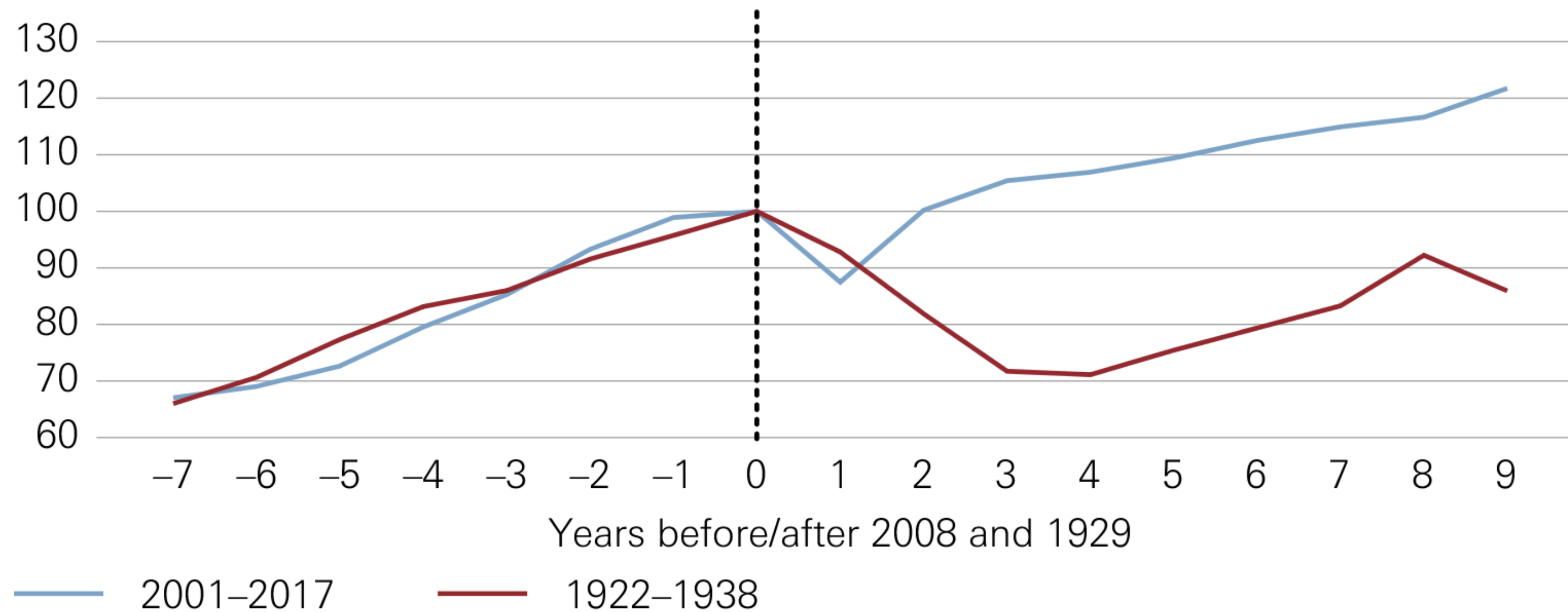

Chart 2

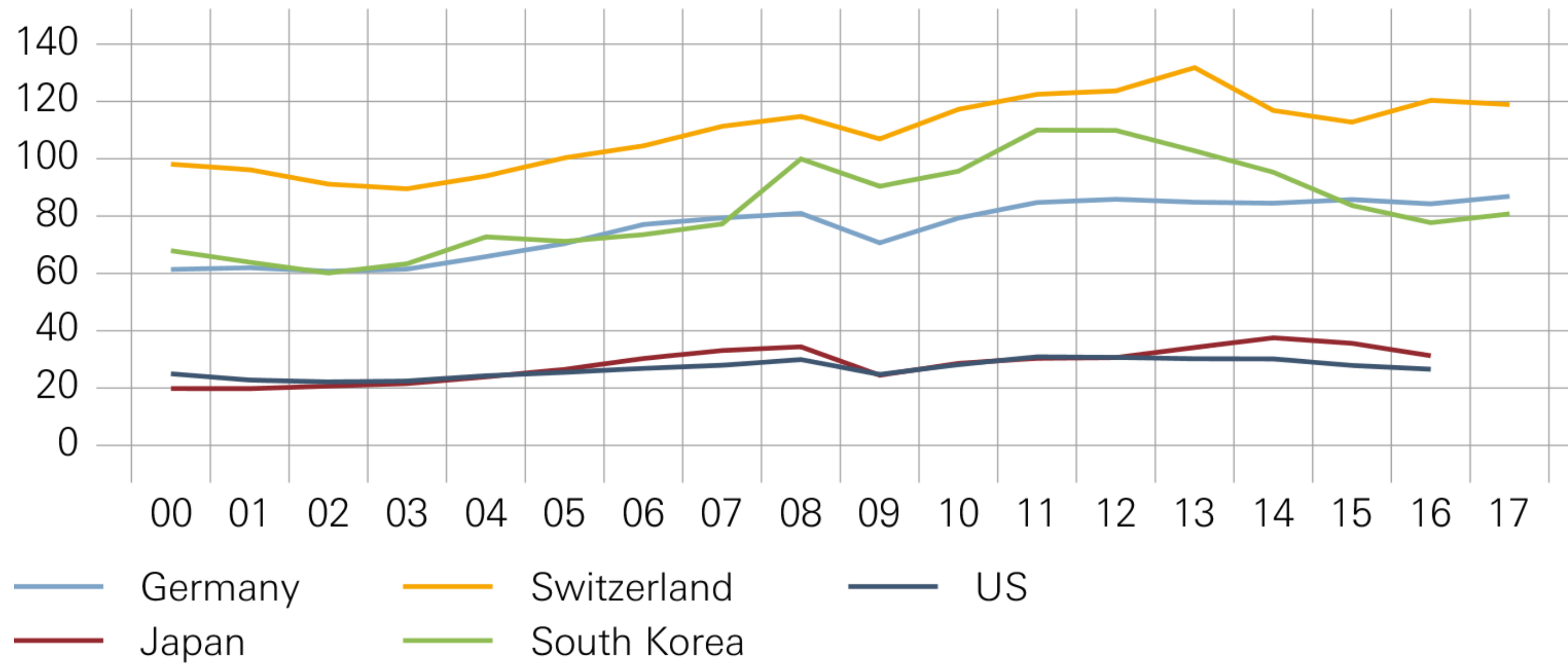

Chart 3

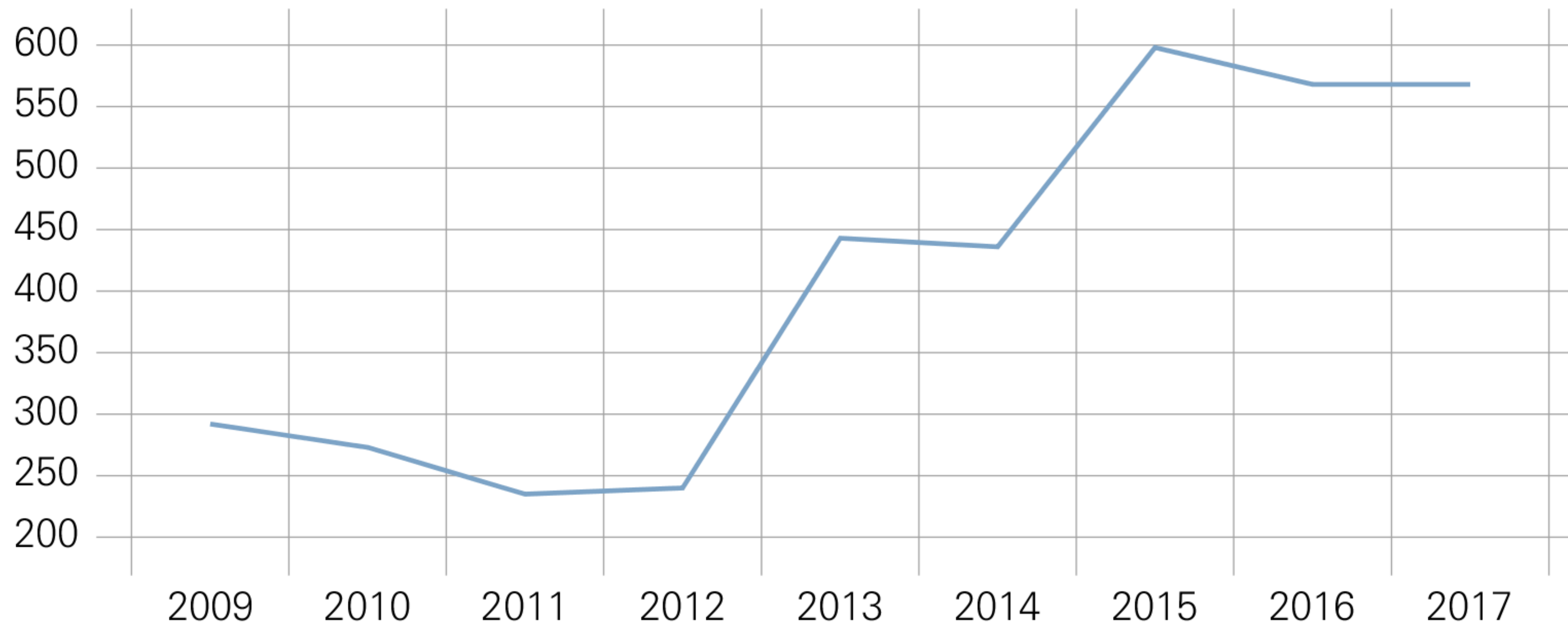

Chart 4

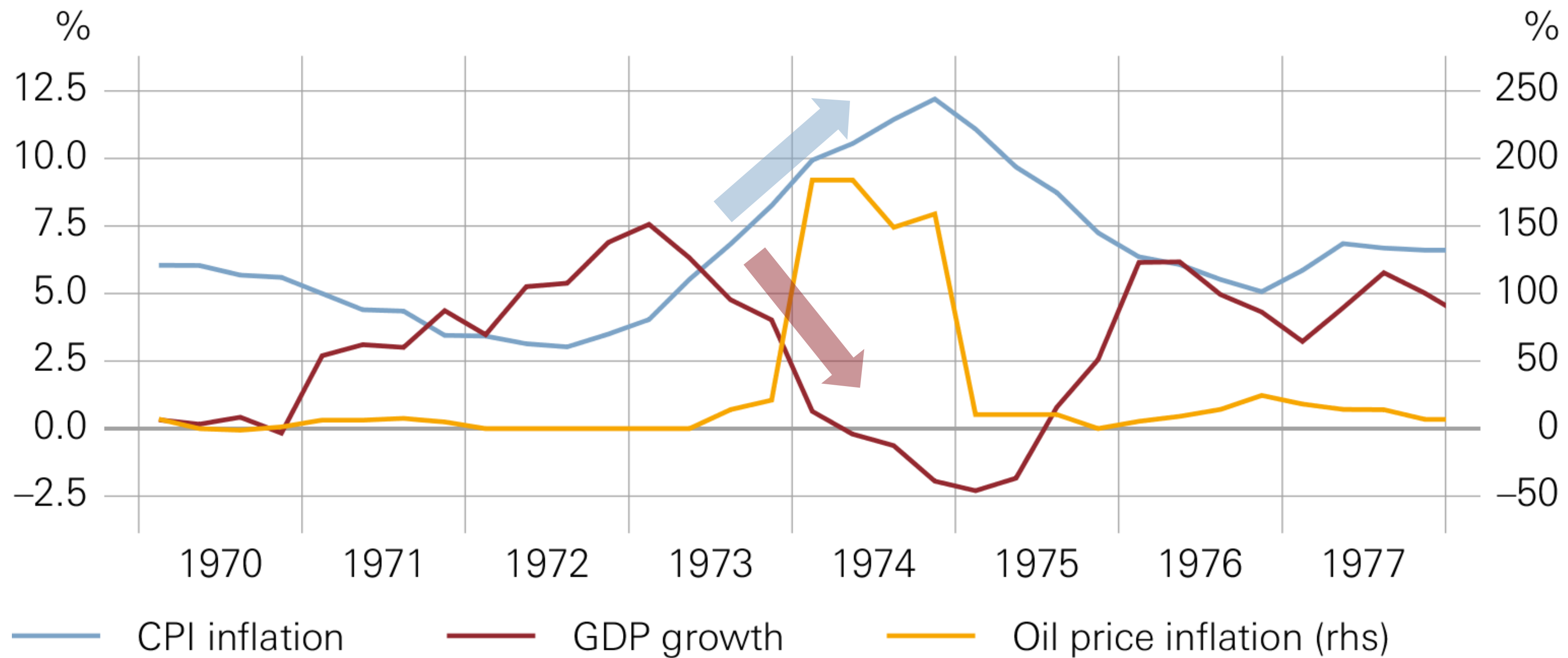

Chart 5

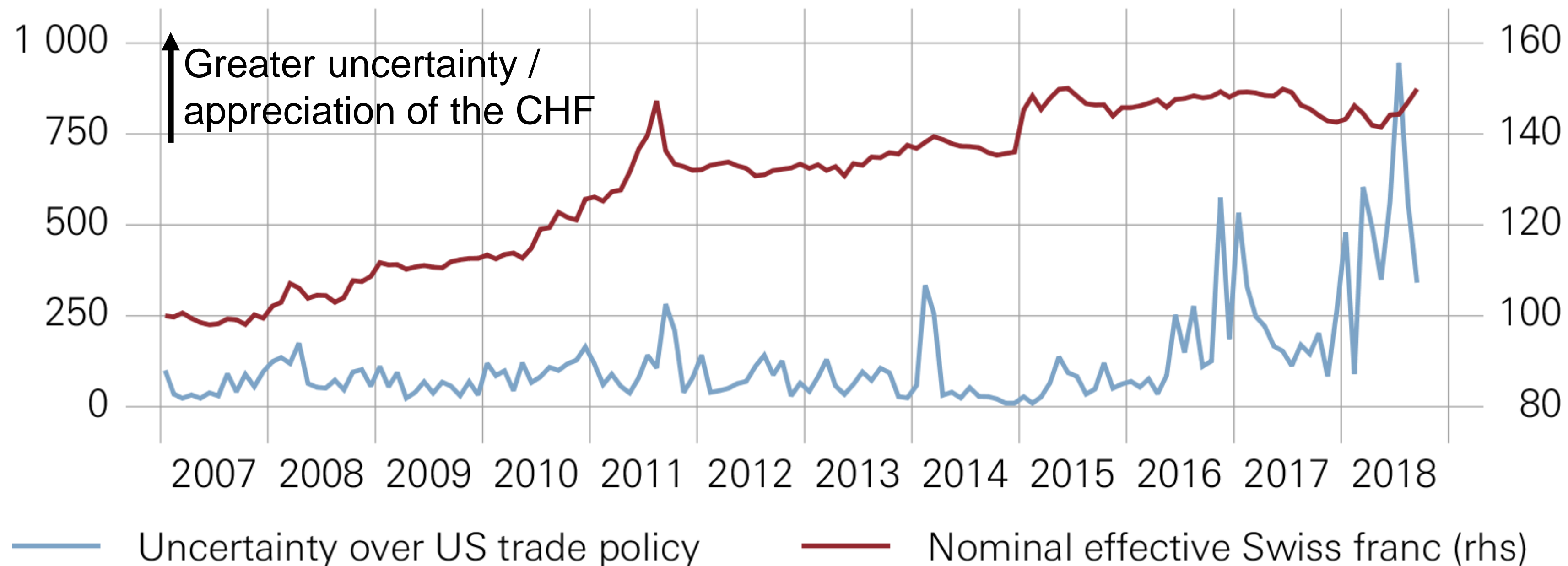

Chart 6