Interview article in the Japanese Weekly Economist*, January 14, 2020 edition*
(my translation from the Japanese original)

US-China "Truce" Was Inevitable:
Negative Impact of Trade War on US Becoming Clear

In mid-December 2019, the US and China reached an agreement, allowing the tariff hikes and expansion of coverage to be deferred. Too much optimism on the US economy is not warranted.

Paul Sheard, Harvard Kennedy School Senior Fellow

The negative impact on the US of the trade war with China has become clearly manifest. Specifically speaking, net exports (exports net of imports) and manufacturing business investment have deteriorated.

If you compare the eleven quarters of the Trump Administration, from the first quarter of 2017 to the third quarter of 2019, with the prior eleven quarters of the Obama Administration, average real GDP growth for both comes in at 2.6% [q-o-q, saar]. However, if you go back two quarters and do a nine-quarter comparison, the difference in favor of Trump was 0.7 percentage points. One quarter back, the ten-quarter average growth difference shrank to 0.3 percentage points and after eleven quarters the growth difference disappeared.

Average US real GDP growth in the five quarters since the US-China trade war started in Q3 2018 has been 2.2%, clearly down from the 2.9% before the trade war begun. In particular, looking at the average contribution of net exports to average real GDP growth, what was 0.0 [pp] before the trade war began, in the five quarters since is minus 0.5 [pp], detracting from growth. The contribution to growth of manufacturing business investment has similarly deteriorated.

President Trump has based his appeal on using protectionist policies to try to revive US domestic manufacturing and expand employment as a result. But manufacturing makes up only 8.4% of total US employment. Even if Chinese products are shut out and there is a revival in manufacturing, not much employment growth can be hoped for.

In the 34 months [for which there are data] since the Trump Administration began, monthly non-farm payroll growth has averaged 193,000, which is below the average monthly increase of 227,000 under the Obama Administration in the equivalent prior period. Looking just at manufacturing employment growth, at 12,000 per month under Trump it has been almost double the 7000 recorded under Obama, but recently manufacturing employment has been shrinking.

One or two rates cuts?

Even though the influence of the manufacturing sector on economic growth has waned with big changes in industrial structure towards the IT and service sectors, President Trump's support base is in "rust belt" states like Michigan and Wisconsin. It was indeed because he won support in these areas that he captured the presidency.

Precisely because of that, I think it was the hidden intent of the US to maneuver towards a temporary truce in the trade war with China, even if it had to compromise somewhat. Nor, considering domestic economic conditions, would the Chinese have wanted further increases in tariffs and an expansion of items covered. As expected, on December 15, the US and China declared a "truce" and the increase in tariffs was deferred.

The Trump Administration is likely to keep up its pressure on the Federal Reserve, which was forced to abandon its rate hiking at the start of 2019 and to cut rates three times from July. Monetary policy will depend on the course of the economy, but if real GDP growth dips below 2%, it is likely that demands [on the Fed] to cut rates will grow. In December 2019, the median forecast of Federal Open Market Committee participants was for rates to stay on hold in 2020, but if the headwinds from trade wars strengthen, the Fed may be forced to cut rates once or twice.

Paul Sheard: Born in Australia in 1954, he received a PhD from the Australian National University and served as chief economist of Lehman Brothers, Nomura Securities, and S&P Global, and as S&P Global Vice Chairman; he has been in his current position since 2018.

[Interview conducted in Tokyo on November 27, 2019; data updated for latest releases.]