Protectionism Could Mean a Dilemma for Central Banks

Central banks usually manage their monetary policy based on an inflation target. Developments in the economy and unemployment rate are nonetheless watched closely, as they are a good indication of inflationary pressures. A high unemployment rate typically goes hand in hand with a low inflation rate, and vice versa. However, inflation can rise at the same time as the unemployment rate. That is what we call economic stagflation. With greater protectionism comes a higher risk of stagflation, and central banks could be faced with a dilemma.

Protectionism halts economic growth and employment. The accumulation of all sorts of trade barriers means that countries are losing out on benefits from specialization and comparative advantages. In addition, weaker competition between companies would probably mean lower growth-generating investments in the long term, such as in research and development. Lastly, more difficult access to international markets would reduce companies’ ability expand and benefit from returns to scale.

Despite decelerating the economy, increased protectionism would still tend to be inflationary. First, it would have a direct effect coming from higher import costs. This could be mitigated by movements in the exchange rate or efforts to find cheaper substitutes. The scope of these mitigation mechanisms would, however, decrease in a scenario where protectionist measures are significant and widespread, and where exchange rates are also manipulated. Inflationary pressures could also arise from reduced competition and productivity. Lastly, households and businesses could expect more inflation in the future, which would mean more persistent increases in the inflation rate.

In a stagflation context, if central banks decide to offset inflationary pressures with restrictive monetary policy, they will worsen economic hardship. If, instead, they choose to stimulate the economy, they risk dangerously accelerating inflation. The choice is not an easy one, but it could nonetheless be slightly more advantageous to avoid an escalation in inflation in order to prevent inflation expectations from increasing too much, which may require greater effort to bring inflation back to the target and potentially generate more damage to the economy.

### IMPLICATIONS

If protectionism increases, central banks might have a difficult time lowering interest rates, even though they could raise them. However, this forecast is mitigated by certain factors. First, the increase in protectionism would have to be significant and widespread to really threaten stagflation for the global economy. Consideration then has to be given to central banks’ starting point for unemployment and inflation. In Europe and Japan, inflationary pressures continue to be very low, which would provide some flexibility. In Canada, the central bank could wait until the inflation threatens to sustainably exceed the upper bond of the inflation target before acting. As for the United States, it is generally recognized that the large size of its domestic market exerts some influence over global prices. That could limit inflationary pressures. In closing, inflation expectations could remain fairly anchored to inflation targets.

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