Does Trump Really Want a Strong Dollar?

Economic policy coherence would not appear to be one of Donald Trump's strong suits, especially insofar as US dollar policy is concerned. In championing his "America First" policy, President Trump has repeatedly railed against countries for currency manipulation and has endlessly complained about the large US trade deficit. Yet, at the same time, he has been vigorously proposing both a highly expansionary US budget policy and a protectionist trade policy that would more than likely lead to further dollar strengthening and to a marked worsening in the US trade balance.

Among the more consistent of Trump's election campaign themes was the notion that the United States was being ripped off by foreign countries and that a principal objective of his administration would be to eliminate the country's trade deficit. Since coming to office, Trump has singled out countries like China, Germany, Japan and South Korea as being serial currency manipulators. He has also threatened China and Mexico with high import tariffs and has vowed that he will renegotiate multilateral trade agreements like NAFTA to the United States' advantage. To underline his seriousness in this course of action, he has named well-known trade hawks Peter Navarro and Wilbur Ross to senior administration positions.

Trump seems to believe that pressuring countries to desist from currency manipulation and erecting import tariff walls will be sufficient to help eliminate the US trade deficit. In so doing, he is overlooking a basic point of economics. Arithmetically, a country's saving-investment balance determines the size of its trade balance. If a country reduces the rate at which it saves and increases the rate at which it invests, its trade balance will worsen. Conversely, if a country increases the rate at which it saves and reduces the rate at which it invests, its trade balance will improve.

Seemingly oblivious to this fundamental point of economic arithmetic, Trump is proposing a highly expansionary budget policy at the very time that the country is close to full employment and that wage pressures are rising. In particular, he is suggesting that far-reaching and seemingly unfunded cuts be made to both corporate and household tax rates. Specifically, he plans to cut the US corporate tax rate from its present 35% to 20%, and he intends to simplify the personal income tax system to one of three tax brackets at much lower rates than at present. Independent think tanks estimate that these tax cuts could cost the US budget anywhere between $3 trillion and $7 trillion in lost tax revenues over the next ten years.

Further compromising the US budget position, Trump is also proposing large public spending increases. Most notably, he keeps advancing the idea of a $1 trillion increase in infrastructure spending over the next decade and a large increase in the country's defense budget.

Trump seems to be premising his expansionary budget proposals on the unrealistic hope that his economic policies will cause US economic growth to somehow accelerate from its present two percent annual rate to around three to four percent. He hopes that faster economic growth of this magnitude would generate additional tax revenue collections to keep his budget proposals tax-neutral.

Never mind that most mainstream economists, including those at the Federal Reserve, estimate that the country's long-run growth potential is now below two percent. Never mind

Desmond Lachman, American Enterprise Institute, Washington DC, USA.

also that Trump's proposal to deport immigrants on a large scale must be expected to further reduce the country's economic growth potential.

Should a meaningful pickup in economic growth not materialize, the net effect of these tax and public spending policies will almost certainly lead to a significant widening of the budget deficit and to a corresponding decline in US public savings. At the same time, Trump's infrastructure policies and his proposed sweeping regulatory reforms could increase the country's investment rate. Coupled with a decline in public savings, that would almost certainly lead to a substantial widening of the US trade deficit.

A further basic weakness of Trump's budget proposal is that it would involve a significant fiscal stimulus to the US economy at the very time that the economy is at or very close to full employment, as mentioned above. If carried through, such a policy is bound to require the Federal Reserve to raise interest rates more than it is currently contemplating as a means to contain inflation.

One of the distinguishing characteristics of the global economy right now is the divergence of monetary policy stances among the world's major central banks. At a time when the Federal Reserve is embarked on a path of trying to normalize interest rates, the European Central Bank and the Bank of Japan are still engaged in aggressive rounds of quantitative easing in an effort to kick-start their moribund economies. Should Trump's fiscal policy plan force the Federal Reserve to raise interest rates at a faster pace than it is presently contemplating, this will only serve to widen the divergence in the monetary policy stances of the various central banks.

Another distinguishing characteristic of the world economy right now is the very high level of corporate borrowing in emerging markets. As the Bank for International Settlements (BIS) keeps warning us, emerging market corporate borrowing has now increased to almost 100% of GDP, while their US dollar-denominated borrowing has increased by around $3.5 trillion since 2008. Little wonder then that the BIS worries about the risks to the global financial system from overly rapid increases in the strength of the US dollar and in US interest rates.

Since the November election, the US dollar has already appreciated significantly to its strongest level in the past decade. It has done so in anticipation that a Republican-controlled Congress is very likely to go along with Trump's budget proposals and force additional Fed tightening. One has to anticipate that if these budget proposals become a reality, they will only serve to propel the US dollar to ever-higher peaks.

The last thing that the country now needs if it is to reduce its trade deficit is a further appreciation of the dollar. Such an appreciation would be the equivalent of the United States cutting import tariffs and imposing export taxes across the board. Incentivizing imports and dis-incentivizing exports is completely at odds with the goal of reducing the country's trade deficit.

A real concern is that, as the US external deficit widens on account of a reckless budget policy approach, Trump will double down on his interventionist and protectionist approach to trade matters. As underlined by his recent interventions with the Carrier Corporation and with Boeing, this seems to be his preferred way of dealing with trade issues. If he does go down that path, he will risk inviting trade retaliation by US trade partners, which could lead the global economy down the road to the beggar-thy-neighbor policies of the 1930s. As surely even Trump must know, such policies, as epitomized by the Smoot-Hawley Act, hardly had a salutary effect on either the US or the global economies.