FROM THE

FOUNDER

Could the Trump Greenback Become a Problem?

At the beginning of February, President Donald Trump reportedly called his national security adviser at 3:00 a.m. to ask whether a strong dollar was good or bad for the economy.

He was right to ask: The Trump dollar could strengthen significantly and become a global economic and financial headache—and trip up the president's entire economic policy.

Let's begin with this historical comparison: The Trump stimulus plan seems to be a version of the Reagan domestic agenda (big tax stimulus, higher government spending, and deregulation). In the early 1980s, those policies produced a soaring dollar. By the mid-1980s, the greenback had appreciated so much that U.S. policymakers began to worry about an exploding trade deficit and potential trade war, particularly with Japan. In response, the industrialized world (led by the U.S. Treasury) organized the Plaza and Louvre Accords—international agreements to use foreign-exchange intervention first to stabilize and then to bring down the dollar's value.

This comparison to the Reagan years is the prime reason why, from November 8, 2016, through January 3, 2017, the U.S. dollar index jumped 6.43 percent.

But here's the problem: A soaring dollar in today's global economic and financial world will have an impact on a lot more than trade imbalances. It could affect the value of global debt, the cost of energy, and, perhaps, the stability of the world's banking system. The potential for damage is significant.

So buckle your seat belt. In both the 1980s and 1990s, a soaring dollar result was serious worldwide financial volatility. True, the president's protectionist rhetoric and anti-foreigner sentiment could have an effect in reversing capital inflows, making a rise in the dollar unsustainable. But recent experience (NATO, one-China policy) shows Trump's bark is often more extreme than his bite.

If the dollar surges, it is not clear a Plaza Accord II is even possible. Conditions aren't the same as those that prevailed in the era of cooperation of the 1980s, when emerging markets, including China and India, represented only 20 percent of the world's gross domestic product. Today, they account for almost half of output. Many, if not most, of these nations are hardly receptive to U.S. leadership on anything. Because

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exports represent from 25 percent to 45 percent of their GDP, the world's emerging markets, as well as most of the developed world, seem committed to a relatively weak currency against the dollar for trade purposes.

But there is an even more important difference. Unlike now, the world in the mid-1980s wasn't sitting on $20 trillion in dollar-denominated debt, half held by emerging markets ($20 trillion is about the size of the U.S.'s GDP). The world's banks were not fragile and undercapitalized as many are today. European and Japanese banks weren't as hugely exposed to emerging market debt.

In a nutshell, the potential problem is that if the dollar continues to soar in strength, it is not just the U.S. trade deficit that could jump. The value for the rest of the world of that $20 trillion in dollar-denominated debt would rise, too. Emerging markets will then see their debt exposure skyrocket. At the same time, the cost of commodities, including energy, will increase. Why? Because throughout the world outside of the United States, commodities are denominated in dollars. The risk is a series of potential emerging-market defaults, or disguised defaults, that wreak havoc on the industrialized world's banking system.

Consider the recent flow of capital into the U.S. economy that has put upward pressure on the dollar. Since the 2008 financial crisis, there has been an unexpected hunger by foreign investors for U.S. financial assets. And it is not just the rich Chinese and Russian investors who poured in capital to escape potential political uncertainty back home. Germany invested heavily, buying up U.S. mid-sized companies. Those inflows have had a dollar-strengthening effect.

Since 2008, foreigners have accumulated more than $23 trillion of U.S. financial assets (not counting financial derivatives) in the form of Treasury securities, corporate stocks and bonds, and foreign direct investment, according to the Federal Reserve. By comparison, in the twenty years up to 2008, foreigners accumulated less than $14 trillion in U.S. financial assets. U.S. asset purchases today by foreigners have been happening at more than double the rate of the pre-financial crisis era.

The reason for these capital inflows is that, as uncertain as things are in the United States, the rest of the world looks worse. With globalization receding, international investors see the U.S. economy as flexible and well-equipped to withstand a decline in global trade in a re-regionalizing world economy of breathtaking technological change. In addition, Americans are still committed to the rule of law. That's not the case in China and Russia. And the future of the eurozone seems hazy.

This upward dollar pressure is also likely to continue if, in reforming the U.S. corporate tax system, the United States moves to the border-adjusted tax system being discussed in Congress. A new 20 percent corporate tax rate would be levied on imports with no tax on exports. Further dollar appreciation would be highly likely, according to estimates by the Tax Foundation and even the writers of the tax proposal itself on the House Ways and Means Committee.

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Finally, there is the issue of the Fed's role in contributing to dollar appreciation. So many nations today manipulate their currencies relative to the dollar by adjusting their interest rates (through the buying and selling of bonds) relative to U.S. interest rates that the Fed has essentially become the world's central bank. Late last year, for example, when Chair Janet Yellen's Fed raised short-term U.S. rates by 25 basis points, short-term rates in most other countries rose, too, even though it made no sense economically for those economies to impose a higher cost for credit at this point in their business cycles. Yellen's suggestion of three more rate hikes by the end of 2017 will almost certainly be damaging for the rest of the world, economically and financially. At the same time, those hikes will probably put even more upward pressure on the dollar. That's because higher yielding U.S. bonds will become more attractive to global investors.

Every time he appears before Congress, U.S. Treasury Secretary Steven Mnuchin needs to be asked about the administration's dollar policy and whether contingency plans are being put in place in the event of a global debt crisis. We need to find out how he and the president plan to handle this complicated economic and financial Rubik's Cube that is creating such presidential insomnia.

—DAVID M. SMICK

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