

## *Les Matinales du Club*

# Trump, trade and the dollar

## Compte-rendu

*CHAIRÉ BY CHRISTOPHE DESTAIS, Deputy-director of the CEPII*

### Speaker

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## Barry Eichengreen

This presentation is about the implication of Trump policy on tariffs and trade on the US dollar.

A tariff makes imports more expensive and shift spending by US consumers toward locally produced goods. However, the US economy is already at full employment, so it does not have any capacity to produce more goods, and **something else has to adjust: the real exchange rate.**

This adjustment can have two forms: the US inflation rate can go up, or the dollar exchange rate can appreciate. **As the Fed is committed to its inflation target, the adjustment will be made through the dollar exchange rate.**

**While the dollar should have been strengthening during Trump's first 400 days, why did it go down?**

The answer to this question should be consistent with the answer to the following question: **Why has the dollar recently strengthen?**

- ⇒ One consistent explanation to both questions is that before March 2018, there were no actual tariffs to drive up the dollar, only tariff talks. Trump's steel and aluminum tariffs only materialized in March 2018, leading to dollar appreciation.

There are two problems with this explanation:

- If US tariffs are dollar positive, then foreign retaliation should be dollar negative. But so far retaliation has been swift and proportionate.
- Most of Trump's tariffs are tariffs on intermediate goods, and not final goods. Households don't buy steel and aluminum; they buy products made out of these metals. As these local goods are not produced locally anymore, these tariffs switch consumer spending towards imports of final goods. That's why the dollar has to weaken to offset shift.
- ⇒ For these reasons - as I already explained in a paper in 1983 - **tariffs on intermediate goods tend to be exchange negative.**

Trump's goal is to put goods manufacturing jobs back to the US, but what he's doing is paradoxical as steel and aluminum are inputs into good manufacturing jobs, and **these tariffs make it harder for the US firms to be competitive.**

The same is true of Trump's Section 301 tariffs (imposed in response to intellectual-property-rights abuses), which allows him to impose tariffs when foreign practices or subsidies are doing "significant damage" –whatever that means - to the US economy. Indeed, he mostly imposed tariffs on intermediate goods, like semi-conductors, again making downstream producers less competitive.

The same is again true of abrogating NAFTA or slapping domestic content requirements on motor vehicles imported into the US from Canada and Mexico:

- Doing so makes sourcing parts and components more expensive.
- The Peterson Institute estimates that these measures will actually reduce US motor vehicle employment by at least 2 per cent.

The question is: why would an administration seeking to boost manufacturing employment would take such counter-productive measures?

- ⇒ **A simple answer is that they don't know what they're doing**

Indeed, Trump administration policy is clearly missing the point:

- Trump's tariffs won't create additional employment, since they will simply be offset by the exchange rate.
- They won't enhance export competitiveness, since they're taxing foreign-sourced inputs rather than outputs.

- They won't boost productivity because they're shifting resources away from the dynamic, technologically-progressive high-tech sector toward old-line manufacturing.
  - o Which is precisely the opposite of what the Chinese are doing in terms of choosing to subsidize particular sectors.
- They won't make the US more secure (Section 232 of the Trade Adjustment Act of 1962, which cites national defense, was the basis of the steel and aluminum tariffs.
  - o They antagonize US allies.
  - o The defense industry is one of the few that still relies on steel and aluminum bigtime.
  - o Is importing steel from Canada a national security risk to the United States? (We import hardly any steel at all from China)

**Two conclusions follow:**

- **US trade policy makers are incompetent.**
- **US trade policy, such as it is, cannot explain the dollar's recent strength.**

Whereas the first conclusion is self-evident, the second one requires pondering possible alternative explanations for the dollar's strength.

There are actually five potential causes for the dollar recent strengthening:

1. The changing US policy mix
2. Emerging market angst
3. Italy weighing on the euro
4. Global trade growth slowing
5. China not rebalancing

1. The changing US policy mix

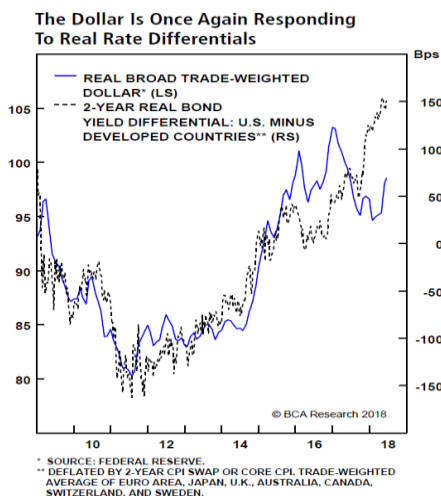
**What is happening now in the US bring us back to the 1980's**, when Reagan was elected President and Volcker became the chairman of the Fed and decided to raise interest rates and Reagan initiated his supply-side revolution by cutting taxes and reducing the budget. This policy mix of looser fiscal policy and tighter monetary policy resulted in a dramatic appreciation of the dollar, which created conflict between countries. The Plaza Accord (1985) intended to bring the dollar down, led to the bubble burst in Japan, followed by the lost decade...

⇒ The logic there was:

- o Looser fiscal policy sucks in more foreign-sourced goods.
- o Higher interest rates attract more foreign funding, as needed to finance the current account deficit.

The same logic is applying now:

The Fed has been pushing up interest rates relative to interest rates in the rest of the world, while the dollar is responding accordingly to what had been seen in the 1980's.



The appreciation of the dollar might have been limited by this big shift not only in fiscal policy in the

US, but by a shift of fiscal policy in the US relative to the rest of the world. Fiscal policy in the US is now incredibly loose after the big tax cut at the end of the year, whereas fiscal policy in Europe is tight. The euro zone is running a primary budget surplus of 1% of Euro zone GDP, when the US is running a wide deficit.

## 2. Emerging market angst

If the emerging markets problems are linked with the US monetary policy, some economic policy mistakes have also been made in Argentine and Turkey and there has been political noise in Brazil and elsewhere.

Emerging markets as an asset class have no longer been receiving capital inflows as they had been until the end of 2017, and they are not experiencing capital outflows. Foreign capital is thus not supporting their currencies anymore relative to the dollar. These countries need weaker currencies, since they can no longer, for the moment, finance current account deficits by borrowing abroad.

## 3. Italy weighing on the euro

The March election and new government raise at least the possibility of a clash between Italy and the Commission and even a disorderly exit from the euro. My view remains that there is room for compromise.

Indeed, Italy has at least some fiscal space as a result of low interest rates and large primary surpluses.

The Commission should allow the government to use it, contingent on the latter also committing to supply side reforms.

But nothing guarantees this happy outcome, and in the meantime Euroscepticism is alive and well (which is euro negative and therefore dollar positive). This situation creates uncertainty, which is not good for investment and economic prosperity for the whole euro zone. But it sensibly coupled that with forward guidance, indicating that there would be no rate hikes “at least through the summer of 2019. So the interest rate differential between the dollar and euro will continue to grow, supporting the greenback.

There’s an active debate (in US circles at least) about whether Italy (a) suffers from deep structural problems (immensely large tax wedge, inefficient large-firm sector) or (b) has just fallen behind since the global financial crisis because of its failure to use fiscal policy countercyclically and failure to clean up its banking system.

I am a firm believer that the answer is: both.

- Figure at right documents that labor-productivity problems predate the global financial crisis.
- But it also shows that productivity, especially multifactor productivity, has continued to worsen since.

## 4. Global trade growth slowing

The period when global trade grew even more quickly than global GDP is now over. This can be explained by the fact that the process of supply chains going global reached its limits, and maybe by protectionism.

If the growth of global trade is now slowing, that will be good for countries and currencies that are less trade dependent (the United States).

## 5. China not rebalancing

It is ironic that the trade war between the US and China is occurring when China has widely reduced its current account surplus. It was 10% of Chinese GDP in 2007, when it is now 1.5%.

The question is whether these progress are sustainable or not. The current account surplus is due to the excess of Chinese savings over Chinese investment, and China reduced its surplus by raising its investment. But is it possible for China to invest 28% of GDP productively?

The increase in consumption has not materialized yet, Hence **the continued intervention in the foreign exchange market to support the demand for Chinese goods** and maintain the Renminbi down... which might be a cause for the dollar appreciation.

- ⇒ There are multiple causes for the dollar appreciation, **and there are multiple reasons for thinking that it cannot be sustained in the longer run.**
- ⇒ And there are multiple reasons for thinking that **it can't be sustained in the longer run.**

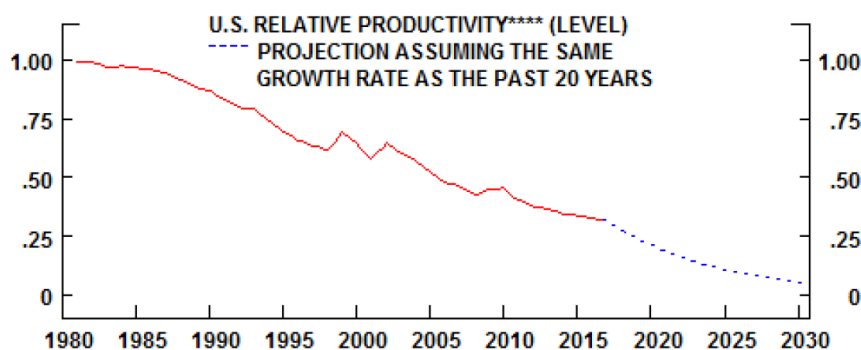
Prospects for the dollar in the longer run:

**In the longer run, the dollar is likely to decline** due to three factors:

1. International productivity differentials
2. Changes in America's geopolitical position
3. US NIIP (Net International Investment Position) and the demand for Treasuries

### 1. International productivity differentials

The real effective exchange rate tends to move with productivity



If productivity in one country does not increase as fast as its competitors, its prices should decrease in order to stay competitive, which means that the real exchange rate – through combination of nominal depreciation and deflation - will have to decline.

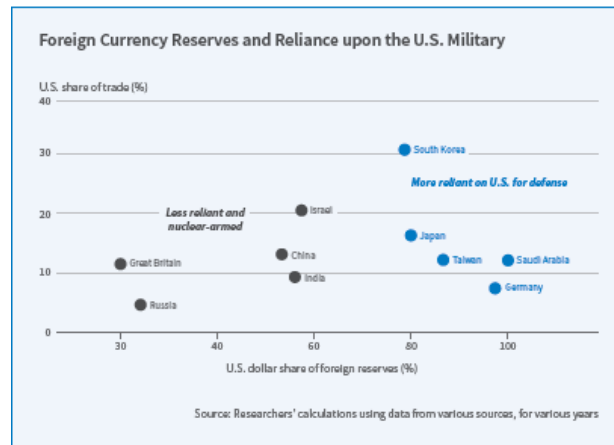
Well, it is clear that due to the rise of emerging markets, the US productivity has been declining relatively to the rest of the world has been declining over time.

Moreover, the US productivity is likely to decline relatively to the rest of the world as advanced economies are more exposed to secular stagnation than other countries.

### 2. Changes in America's geopolitical position

The dollar's exorbitant privilege, which has been one of the drivers of the dollar's strength, is likely to be lost in the longer run. Why so?

- If the US policy is no longer predictable, investors will be less and less eager to buy Treasury bonds.
- If the US is no longer a reliable geopolitical partner. Indeed, foreign currency reserves are historically correlated with reliance upon the US Military.



### 3. A deteriorating net international investment position

Doubts about the deficit may grow as the US becomes more indebted to rest of the World, as the US current deficit gets larger.

⇒ So the question is: could there be a crisis of confidence at some point?

If foreign investors worry about the value of their Treasury bonds, they will have to be compensated by dollar appreciation.

The dollar has thus to depreciate now to deliver appreciation later:

In the short run, this has the salutary portfolio-balance effect of reducing the weight of Treasuries in foreign portfolios.

- But it could conceivably occur via a dollar crash...

So, a dollar crash is conceivable if:

- Trade and other conflicts create the perception that the US is an unreliable ally
- Another debt ceiling imbroglio occurs
- Foreign investors have doubts about US debt sustainability

As a conclusion, it is hard to be positive about the dollar in the longer term.

## Q&A

### Which currency could replace the dollar as the international currency?

**Barry Eichengreen:** There are few alternatives. Since 2008, the share of international bonds nominated in euros has gone down, as well as the euro share of international reserves because it has been a lot of financial and political turmoil in Europe. Even if the European single currency's flaws are meant to be solved in the longer term, with the creation of a European fiscal capacity, this will be a long process.

China has trouble deepening its financial markets, and it even had to tightened capital controls in 2015. However, China is trying to get more central on the international arena through its Belt and Road initiative and through trade agreements. But historically, every international currency has been that of a Republic and a democracy, which is not the case of the current Chinese regime... Indeed, investors need to know that some checks and balances exist, they need to know that the financial rules are not subject to be changed unilaterally.

One scenario is that the dollar falls out of favor and there is initially no alternative to replace the dollar. There would be no liquid asset to foster globalization.

**Is the Trump administration actually incompetent, or eager to please Trump's political base?**

**Barry Eichengreen:** It is true that its trade policy is in line with its populist speeches, blaming foreign countries not to treat the US in a fair way.

But for instance, American soy beans exporters are not satisfied with Trump's policy because they see the link between Trump trade policy and the Chinese retaliation against them.

We should not overestimate Trump administration's lucidity, as there are actually few skilled economists in this administration.

**Is the EU response the US protectionism appropriate, or will it worsen the situation?**

**Barry Eichengreen:** Even if the EU should defend its interests, it should not do that same mistakes as the Trump administration.

**How do you explain the low volatility of the dollar in the last five years in this difficult environment?**

**Barry Eichengreen:** Until 2017 the US has been a safe haven whereas the world was full of uncertainty.

**As a lot of the current Chinese debt is not sustainable because of the lack of sustainability of investments, it will eventually be turned into Chinese public debt. This means China might offer "safe assets" to the market place. What could be the consequences on the global economy?**

**Barry Eichengreen:** If China turns its private debt into public debt, it might make the internationalization of Renminbi easier as more investors would be interested in these public bonds rather than in low quality corporate bonds. But at the same time, the capital controls will remain, putting limits to the process of internationalization of the Chinese currency.

**As the US has stopped renaming the judges from WTO, this organization will not be able to work before late 2019. What will be the consequences of such an unusual situation?**

**Barry Eichengreen:**

One possible scenario would be that Trump finally recognized the importance of WTO as he did with NATO which he also first criticized.

Another scenario would be that after eliminating all the independent and moderate thinkers from the White House, Trump goes even further into unilateral aggressive actions.

**Trump is using the dollar to sanction countries who do business with "forbidden" countries, like Russia or Iran for instance. Do you think the US is strong enough to sustain this use of the dollar?**

**Barry Eichengreen:** Some countries have been trying for long to try to be independent from the dollar for instance by dealing with oil in another unit than dollar.

What is new now is that some US allies are subject to US sanctions, and not just Russia or Iran. That's why more and more countries might be interested in using the euro for instance as an alternative vehicle to bypass the dollar.

**In your book on populism, you argue that fiscal policies in the euro zone should remain fully determined by Member States, and that the current discipline imposed to Member States is not justified. Can you elaborate? Why don't you take into account the potential financial spillovers?**

**Barry Eichengreen:** I was actually trying to explain why the euro zone was such a fertile place for populism. I think people in different Member States have different views on the use of their countries'

fiscal policy, and imposing common rules can be problematic in this regard. Moreover, it seems to me that the financial spillovers of fiscal policies on neighbors are relatively small. For instance, if France runs a more expansionary fiscal policy, Germany will certainly benefit from positive spillovers through an increase in its exports, but the French fiscal policy would also have negative spillovers for Germany as it will drive up the euro interest rates. That's why in its recent study, the ECB estimates that these spillovers are relatively small.