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Soaring Trump dollar risks global trade war and China currency crisis, warns Posen

Ronald Reagan's fiscal blitz in the 1980s caused epic twin-deficits, and a global trade crisis. Trump may cause the same distortions

By Ambrose Evans-Pritchard, Como, Italy

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The world's leading currency institute is bracing for a dramatic rise in the US dollar as the Federal Reserve rushes to tighten monetary policy, setting the stage for a protectionist showdown and a fresh debt crisis in emerging markets.

Adam Posen, president of the Peterson Institute for International Economics, said investors have badly misjudged the confluence of forces at work in Washington.

They wrongly assume that fiscal stimulus will come to little under Donald Trump, and are equally wrong that Janet Yellen Fed's will remain dovish as the US nears full employment.

"The Fed is going to be far more aggressive than people think. Our view is that there will be three to four more rate rises this year," he told The Telegraph.

This would amount to a global monetary shock, all the more so since the Fed is also floating plans to reverse quantitative easing (QE) by halting the roll-over bonds as

they mature. This move to shrink the Fed's $4.5 trillion balance sheet may come earlier than originally supposed, perhaps by the end of the year.

The effect of Fed tightening would be to drain dollar liquidity from the international financial system, the exact opposite of what happened in the emerging market boom earlier this decade when so much of the Fed's easy money leaked into East Asia, Latin America, Africa, and the Middle East.

Adam Posen thinks the Fed is going to be far more aggressive than expected

"We expect the dollar to rise by another 10pc to 15pc. The concern is that this will suck capital out of the more fragile emerging markets and lead to fresh capital outflows from China," Mr Posen said.

"It may vary country by country but it could be like the 'taper tantrum'. Malaysia and Brazil look vulnerable to us," he said, speaking at the Ambrosetti forum of global economists on Lake Como.

A hawkish Fed could prove painful for investors still hoping that central banks will come to the rescue whenever there is trouble, be it the 'Yellen Put' in the US, the 'Draghi Put' in Europe, or the 'PBOC Put' in China.

The Fed is itching to show that it is not a prisoner of Wall Street, after being forced to retreat many times in recent years. It effectively delayed rate rises last year due to China's currency scare. Now the coast looks clear.

"Central bankers don't think policy should be constrained just because somebody in the markets is going to lose money," Mr Posen said.

Mr Posen is a former rate-setter on Britain's Monetary Policy Committee, best known for his work with former Fed chief Ben Bernanke on Japan's Lost Decade and inflation targeting.

The underlying argument is that Donald Trump will succeed in ramming through radical tax cuts and fiscal stimulus, causing US federal borrowing to balloon. The Peterson Institute thinks the current account deficit could rise to 5pc of GDP.

Markets have largely written off any serious action by the Trump administration after the failure of his healthcare plan in Congress, but that may be a mistake. Mr Posen said there is no "informational content" in the healthcare fiasco. It is a unique issue. Republicans are far more united on tax cuts.

Mr Posen said the corporate rate is likely to fall from 35pc to 25pc, along with income tax cuts for the wealthy and the middle class, and more generous tax deductions for business. This may be "very bullish" for markets at first, but it stores up serious trouble.

Such a policy at this late stage of the business cycle will cause the economy to overheat, forcing the Fed to jam on the monetary brakes, and sending the dollar through roof.

Japan bashing on Capitol Hill in 1987 when tensions were running high

The 'loose fiscal/tight money' mix will inevitably cause a loss of trade competitiveness, making a mockery of Mr Trump's promises to boost America's export industries and revitalize the manufacturing base.

He is likely to lash out at the China and the rest of the world. "Trade frictions are going to come to a head in two or three years. It is going to be a rerun of the mid-1980s," Mr Posen said.

This could be a big handicap for Britain as it seeks to forge trade deals after Brexit. Mr Posen said the country already risks a trade shock and a productivity squeeze as it leaves the EU single market.

“Brexit is going to be like arthritis. It will be very painful, but it is not going to kill you. We think you could lose a third of the City. That is not a trivial matter,” he said.

The strong dollar episode under Ronald Reagan in the 1980s led to epic ‘twin deficits’ - budget and current account - as well as the worst global trade crisis since the Second World War, with scenes of US Congressmen smashing Japanese computers on the steps of Capitol Hill with sledge-hammers.

Tokyo soothed nerves by agreeing to restrain exports of cars to the US under a 'voluntary' agreement. Such a formula might prove impossible today with China, which accounts for 60pc of America's $500bn (£400bn) goods and services deficit.

Whatever the friction, the US and Japan were close military and foreign policy allies in the 1980s. They were able to navigate the reefs. China is challenging the US for global superpower leadership on every front.

Politicians from the G5 powers ultimately intervened to drive down the Reagan dollar at the Plaza Accord in 1985, with dire side-effects. That attempt to manipulate currencies in defiance of economic fundamentals led - by a complex chain of causality - to the Nikkei bubble in Japan, and to the 1987 stock market crash on Wall Street.

If Mr Posen is right about a further 15pc rise in the US exchange rate, this would push the Fed's 'broad dollar index' to an all-time high of over 140. Nobody knows what this would do to a global financial system that is more dollarised than ever before, and arguably more leveraged to US borrowing costs as well.

Data from the Bank for International Settlements shows that dollar debt has jumped five-fold to $10 trillion since 2002. BIS studies suggest that a stronger dollar automatically causes banks in Europe and Asia to shrink their balance sheets through the effects of hedging derivatives, effectively curtailing lending.

The latest Global Debt Monitor from the Institute of International Finance said there has been a “spectacular rise” in emerging market debt from $16 trillion to $56 trillion over the last decade, pushing the debt ratio to a record high of 215pc of GDP.

Roughly $7.2 trillion of these loans is in foreign currencies. Over $1.1 trillion of emerging market bonds and loans comes due this year. “Refinancing risk is high,” it said.

Of course, China accounts for a large chunk of the debt. This distorts the picture. It has huge internal savings. The banking system is an arm of state.

“It is the left hand lending to the right hand. You cannot really have a financial crisis in China,” said Andrew Sheng, Chief Adviser to the China Banking Regulatory Commission.

"We actually think it would be good for China if the Fed raises rates," he told The Telegraph at the Como forum. That proposition remains to be tested.

Mr Posen said the risk for China is a vicious circle as bad debts are rolled over, and ever more credit is diverted to prop up obsolete state industries and zombie enterprises, ultimately sapping the life-blood out of the economy.

“This is what happened to Japan. It is not exactly a death spiral, but it is very, very bad,” he said.