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Trump 'border tax' threatens global dollar chaos

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President Trump and House Speaker Paul Ryan are allies on tax plans that could have an explosive effect on the world currency system

The threat of sweeping US tariffs against China, Mexico, and any other country that falls foul of President Donald Trump, may be mere noise at this point.

What is not noise is the Republican plan for a "border-adjusted tax" that is just as explosive in its effects, and is emerging as the biggest single risk to the global financial system.

Let us call it the 'Iraq War' of Republican economic policy: strategic folly pursued with dogged certainty by ideologues with limited feel for how the world economy works. "A terrible idea," says Adam Posen, head of the Peterson Institute.

Trade experts mostly agree that this abstruse measure would lead more or less automatically to a spike in the dollar by 15pc to 20pc.

If allowed to happen, this would drain liquidity from a global financial system anchored on dollar-based lending. It risks causing capital flight from China to spin out of control, setting off a full-blown currency crisis in Asia. It is how you cause a global recession.

“It’s a pretty dramatic change. I’m not sure that would all happen very smoothly and there could be lots of unintended consequences," warned William Dudley, head of the New York Federal Reserve.

The US might 'gain' a relative edge of sorts - if measured in strategic terms or in balance of power politics - but chiefly by causing havoc for other countries. America would not gain any prosperity in absolute terms. The blow-back would eventually catch up with the US in any case.

Those "rusted-out factories scattered like tombstones across the landscape of our nation" - as Mr Trump put it in his hair-raising Inaugural - will continue to rust. The only way to prevent this dollar effect is for the president to resort to other drastic measures to hold down the exchange rate.

Mr Trump initially said the border tax was "too complicated" but has since warmed to the theme, offering his own variant. "If you go to another country and you decide that you're going to get rid of 2,000 people or 5,000 people, we are going to be imposing a very major border tax on the product when it comes in," he told business leaders.

Mr Trump has warned US business leaders that they will face ferocious penalties if they shift plant abroad

Kevin Brady, chairman of the House Ways and Means Committee, says the president is now "very much on the same page," as Republican leaders over the plan.

The border-adjusted tax is basically a charge on goods and supplies brought by US companies overseas. The imports can no longer be deducted against tax. By contrast exports would be free from tax. The ploy is an export subsidy in all but name.

Republicans like the scheme because they think they can slip it through the World Trade Organisation, dressing it up as America's answer to VAT in other countries.

The plan is part of House Speaker Paul Ryan's broader tax reform, which aims to cut the corporate rate from 35pc to 20pc. It has some logic. The 'universalist' US tax code causes all kinds of distortions. It is why companies like Google or Apple rely so much on 'transfer pricing' between subsidiaries, and why US firms hold $2.5 trillion overseas.

Yet getting there constitutes a global shock of the first order. "This will trigger a series of emerging market crises," said Stan Veuger from the American Enterprise Institute. He estimates that the burden for companies and states in developing countries with dollars debts will jump by $750bn. Turkish firms alone would face a $60bn hit.

It does not end there. Studies by the Bank for International Settlements show that a rising dollar automatically forces banks in Europe and the Far East to shrink cross-border lending through the mechanism of hedge contracts.

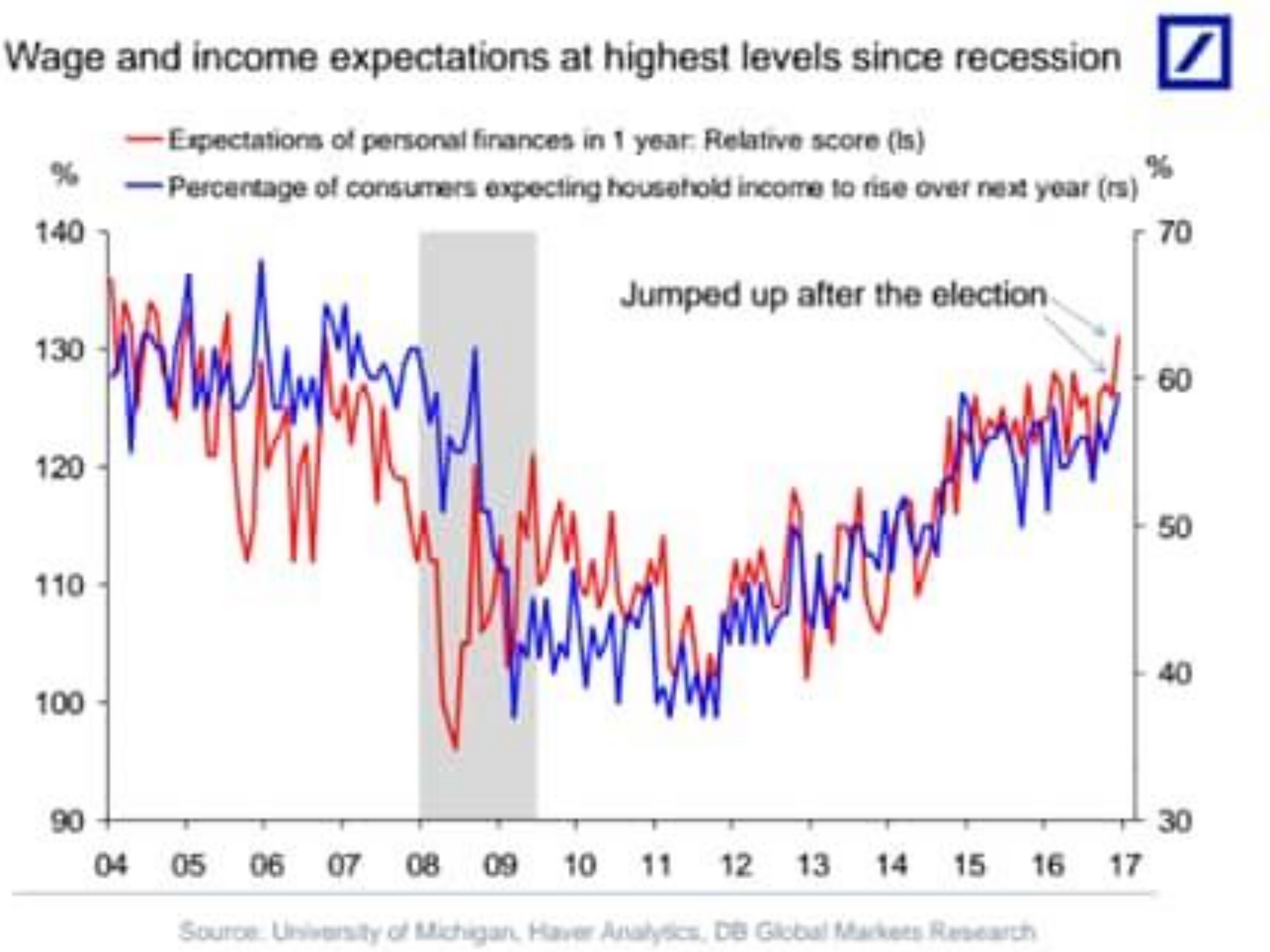
A dollar spike of anywhere near 20pc would send the Chinese yuan smashing through multiple lines of psychological resistance. The People's Bank (PBOC) is already intervening heavily to defend the line of seven yuan to the dollar. Ferocious curbs would be needed to stop the Chinese middle classes funneling money out of the country if it crashed by a fifth.

Junheng Li from Warren Capital says the China's exchange regime is more brittle than it looks. Official data overstates the PBOC's fighting fund by $1 trillion, either because reserves are "encumbered" by forward dollar sales or because they must be held in reserve as a "fiscal backstop" for Chinese firms at risk of default on dollar debts. She expects the system to snap at any time, and without warning.

I strongly doubt whether the Trump-Ryan axis in Washington has any idea what could happen if they detonate a debt-deflation crisis in China, or if they ignite a short-squeeze on $10 trillion of off-shore dollar debt with no lender-of-last-resort behind it. Nor do they care.

The contradiction at the heart of Trumponomics is that the president wants a weaker currency to gain an edge in trade, yet everything he is doing combines towards a stronger currency.

His 'Reaganite' package of tax cuts and military rearmament - leveraged by infrastructure spending - is fiscal reflation at the worst moment in the business cycle. The Fed has already signaled that it will raise interest rates by 50 basis points to offset each 1pc of GDP in fiscal stimulus at this late phase of the eight-year old economic expansion.



US wages are shooting up, a precursor to inflation. CREDIT: DEUTSCHE BANK

Core inflation has risen to 2.2pc. The US labour market is tightening hard. Wages have been shooting up at a 4pc rate over the last three months, the fastest since the pre-Lehman top. The International Monetary Fund says fiscal stimulus risk colliding with "rigid capacity constraints".

The spread of 2-year US Treasury yields over German and Japanese yields - the classic driver of currency moves - has doubled to over 120 basis points since June. This is drawing powerful flows of money into US debt markets. It is a formula for a super-dollar, and it has further to run.

Everything has a late-cycle feel to it. The Cape-Shiller price-to-earnings ratio for the S&P 500 stocks is already above 24, higher than any time over the last 130 years with the exception of the 1929 and the dotcom peak in 2000.

Can Wall Street go higher? Certainly. The creator of the measure, Nobel laureate Robert Shiller, told me in Davos that there may be a final blow-off surge. Mood matters - he argues - and the animal spirits unleashed by Trump's pledge to cut taxes and slash regulations by 75pc could push the Cape-Shiller ratio towards the dotcom record of 45.

This would be followed by a cathartic crash and a day of moral judgment. The Shiller view is that Trump's own supporters will turn against him - and against his wealthy swagger - just as culture turned in the 1930s and people rejected the Coolidge ethos of the Roaring Twenties.

There is no sign yet that Mr Trump is willing to back down on any of his core policies. So my suspicion is that he will try to break out of this dollar trap by leaning on the Fed to delay rate rises and ultimately by ordering intervention to hold down the US exchange rate.

There are precedents for such currency action. The Swiss National Bank vowed in 2011 to spend unlimited sums to stop the franc rising above €1.20 as it battled deflation. The Japanese did it on a nuclear scale in 2003. The Chinese pursued a mercantilist strategy during its growth-spurt, keeping the yuan weak to gain export share.

Recourse to such methods by the holder of the paramount reserve currency would be a different kettle of fish. It would amount to a global free-for-all, a Hobbesian monetary disorder.

Currency intervention is by law a US Treasury prerogative. The New York Fed must in effect do what it is told, if ever ordered to buy foreign bonds. This is the means by which Mr Trump can bend the Fed to his will. Does anybody really think he will resist such a temptation?