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Policy Brief

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Trump and the Dollar in the Reflection of History

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Summary

Fears of disruption in international relationships, raised by Trump's access to power, have been confirmed by his first half-year in office. Uncertainty has spread in international relationships. Surprisingly few in-depth studies in political economy have been made to define "Trumponomics" and to analyze the economic consequences of implementing his intentions for the US and the world. Since the question pertains to radical uncertainty, the usual quantitative methods and indicators go astray. Financial markets are not at ease with political uncertainty. In this environment, the financial community takes refuge in denying that business as usual might be derailed.

However, it may be useful to raise a lively debate in political economy to figure out the rising forces of change that might trigger the unraveling of the financial globalization founded with Reaganomics in the 1980s that spread all over the world with the Washington Consensus.

We will first question the consistency of Trump's revealed intents. Do they amount to a coherent doctrine? What might be the economic consequences? What type of dilemma will he face?

To deepen the analysis, we will resort to history. Can Trumponomics be compared to Reaganomics? Both have claimed to overhaul social relationships in emphasizing supply-side economics. Revisiting the consequences of Reaganomics gives clues for assessing the pitfalls that can undermine Trumponomics, since the initial economic and financial conditions are opposite to those that prevailed when Reagan took office.

Finally, the third part of the paper will try to assess the consequences for the world and for Europe if Trump's policy triggers a dual rise in US interest rates and in the dollar.

1. Introduction

Is "Trumponomics" a consistent economic doctrine? Whether it is or not, can it be implemented, and, if so, what would be the consequences for the US and the world? These questions are relevant whatever the delay and the hesitation in implementing the president's fiscal policy-related announcements. They are key questions since any effects would soon be transmitted to the rest of the world through the changes in the dollar exchange rate. For insights, we will look back to a precedent disruptive episode induced by sweeping monetary and political changes: the early 1980s. Introducing aggressive supply-side economics under the auspices of a proclaimed new era of economic liberalism, the newly elected President Reagan launched the US into the twin deficits (fiscal and foreign) that, combined with a rise in interest rates, resulted in a surge in the dollar exchange rate. There were dramatic consequences worldwide, not least the string of financial crises in Latin America and Africa that led to "the lost decade", giving rise in turn to the Washington Consensus that fostered globalization.

There is still uncertainty surrounding Trump's intentions, and skepticism prevails about their actual feasibility. In such a context, analysis is particularly difficult, but it is useful to rely on the historical findings pertaining to previous similar events. The turn of the 1980s saw the epilogue in the crisis of the post-war brand of capitalism, called Fordism, which was derailed by the systemic inflationary crisis that raged through the 1970s. After ten years of muddling through in the aftermath of the systemic financial crisis of 2007–2009, are we now at a turning point? Is Trump's election, among other recent political events, a harbinger of an incipient overhauling of global capitalism? The Trump paradox lies in advocating "America first" while loathing the international institutions that have sustained US hegemony over the last seventy years. In trying to understand this paradox, we will investigate three main issues.

First, Trump's main boasted aim is to boost economic growth to 3%, using deregulation, tax reform and infrastructure investment. Deregulation and tax reform look like familiar supply-side tools. However, if the objective is not short-lived expansion but sustained potential growth, the financing of the reforms, hence the impact on interest rates and exchange rates, must be accounted for.

Second, we justify the comparison with Reaganomics by asking: What made the latter work for four to five years? What was its macroeconomic legacy? Recalling the initial financial conditions in which Reaganomics arose is important, so as to stress the striking differences with our current circumstances. Elaborating on those differences makes it possible to point out the risks involved in full implementation of the announcements of the US president, should they become an actual policy. To do so, we will stress the dilemma that monetary policy will face, revisiting the 1994 bond crisis to understand the financial dynamic that might be unleashed.

Third, we will highlight the dangerous international consequences, distinguishing between Europe and emerging market economies (EMEs). The world has been enjoying only a shallow recovery since the fall of 2016 in a context of subdued potential growth. The sustaining of this growth is essential for absorbing and consolidating the political changes in the making. Secular stagnation was fostered by the feedback between overproduction in Asia and subdued demand in Europe. How will these large economic regions react to the new US policy mix, combined with protectionist threats? Exploring this issue will help to highlight, in conclusion, how the future of globalization might be at stake.

2. The economic consequences of Trump within the US

In claiming that coordinating government action is as easy as running a business, Donald Trump sends a treacherous message to the US people. As a candidate, he spent months telling voters that hard problems were easy to solve and that trade-offs could be avoided. Nothing is further from the truth. The process linking announcements of reforms, detailed design and sustained implementation will come up against political disruption, especially if they involve substantial, permanent and regressive tax cuts. Furthermore, the politics of healthcare divides people sharply between the principles of individual responsibility, whatever the inequality of incomes, and the principle of universal coverage that all other governments in advanced countries guarantee.

The Trump administration hopes to restructure fiscal policy, with an individual income-tax rate reduced to 33% and a corporate tax rate lowered to 15%. The benefits would be very uneven, according to the Tax Policy Center (Nunns *et al.*, 2016). The tax cuts would amount to more than 14% of after-tax income for the 0.1% richest in income distribution ($3.7m), and to only 0.8% for the fifth poorest ($110). In the middle of the income distribution, the tax cut would be equivalent to 1.8% of after-tax income ($1,010). Consequently, the tax reform would increase the already considerable income inequalities among US households, which might frustrate Trump's electorate and exacerbate political tensions. Political bickering would also arise if broad and bold restructuring of the tax base was abandoned for a straight tax cut.

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Moreover, a rise in the fiscal deficit would result from such tax reforms, since it is unlikely to be compensated by a reduction in spending. Indeed, the infrastructure spending plan would also help to open up a political rift within the Republican majority. Trump and his advisers have promised that between $550 billion and $1 trillion will be spent on infrastructure projects, without much specification, but with the idea that private firms must be in the

lead. If not well managed, this would be a license granted to the multiplication of conflicts of interests. Furthermore, Trump's hostility to environmental policies and his obsession with traditional manufacturing jobs and coal mining, quite apart from the building of a wall at the Mexican border, do not augur well for the enhancing of efficiency and wellbeing expected from the plan. Emphasizing growth without understanding the need to retrain millions of workers and to prioritize the education that is at the root of potential growth in the knowledge economy would spread disillusionment.

After the last G7 Taormina summit, insights into Trump's domestic economic agenda were made public, especially on how the fiscal deficit would be mitigated. Tax cuts for the rich would be partly financed by lower spending on the poor. The Congressional Budget Office (CBO) has analyzed the balance between proposed lower taxes, on the one hand, and savings by the new American Health Care Act after the repeal of the Affordable Care Act, on the other. Over ten years (2017–2026), the loss in tax revenues would be $992bn, more than paid for by the reduction in expenditure on Medicaid and other subsidies (CBO, 2017). With the failure to repeal Obamacare, the tax reform will get even more problematic since the widening of the fiscal deficit would be much larger.

On the spending side of the budget, the political intents are also clear: a big increase in defense spending ($52bn in 2018), partly offset by big cuts in other departments – in particular, cuts in the State Department's own budget and its contributions to international agencies, health and education, amounting to $34bn. Nothing is yet clear about infrastructure spending. Nonetheless, the fiscal choices reveal a confirmation of the political shift away from social progress and globalization, toward hardline conservatism and nationalism.

2.1. The problem of macroeconomic consistency: more harm than good?

Let us recall the overall economic objective: 3% growth. With an ageing population and the growth of the labor force slowing, this aim requires 2.3% growth in total factor productivity (TFP). Such pace has not been achieved over a 10-year period since the late 1960s. For the past decade, TFP growth has been 0.7%. The Congressional Budget Office (CBO), which evaluates the long-run consequences of Trump's fiscal projects, expects a slow recovery to 1.1% TFP growth in 2027 under optimistic assumptions (CBO, 2017). This means that the objective of 3% GDP growth is very unlikely to be met. The most serious economic danger would be an obstinate attitude in the desire to reach this goal.

Such stubbornness is rooted in the political exploitation of supply-side economics. It is vindicated in the mind of its proponents by a misinterpretation of the Laffer curve: lowering tax rates will stimulate growth enough to increase taxes, in such a way that the tax reform will pay for itself. In the original Laffer curve, such "economic effect" arises only if taxes are prohibitive, e.g. if the overall tax rate is higher than 50%. That is not the case in the US. Moreover, at least two other conditions must be met. First, private debt must not be too high; otherwise, firms and households would use the extra revenue from lower taxes to deleverage. Currently in the US, debt levels are still high in some corners of the economy; above all, student indebtedness is worryingly high, although overall household debt has been receding since the financial crisis. The second key condition is that corporations invest the tax-cut money productively in order to increase the supply of goods and services produced in the country. If they immediately hand the money to their shareholders through dividends or share buy-backs, the effect would be watered down. In that case, shareholders might consume more, but the trickle-down effect has always proven insufficient to recoup the lost public revenue due to the lower tax rates. In the present state of corporate governance, as shareholder value principle still dominates, this condition is far from being met.

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2.2. Trump's trilemma

Donald Trump has promised expensive tax cuts, an investment boom and a reduction in the trade deficit. Is it possible to achieve these three goals simultaneously, or is it a new policy trilemma? Achieving the latter of the three promises would be an amazing reversal, as the US has been continuously running current account deficits, driven by trade deficits, since 1982. As a consequence, foreigners now own $8.1trn assets in the US, more than the Americans own abroad. The gap, called "net foreign liabilities", amounts to about 43% of US GDP. Nevertheless, the US residents still earn more from their investments abroad than they pay out to foreigners, for two reasons. First, the "exorbitant privilege" of issuing the key reserve currency makes it cheaper for Americans to raise funds. Second, the US residents own more rewarding assets, in the form of equities, than foreigners do in the US. On the whole, the net capital income received from abroad compensates for the negative balance on goods in the US balance of payments, and hence facilitates the trade deficit.

We will see in the third section how Reaganomics have made the twin deficits in the public sector and in foreign trade soar, the latter from 2.5% GDP in 1981 to 4.9% in 1986. How could Trump's policies, based on similar principles, deliver opposite results? In the Clinton years, growth accelerated from 1994 onwards. The public deficit shrank until it was almost balanced in 2000. However, the current account deficit grew along with the net foreign liabilities, propelled by a booming stock market.

Under Trumponomics, a larger budget deficit and more private investment, if incentivized by infrastructure spending and boosted by tax credit, would certainly raise the trade deficit.
Even assuming that productivity will accelerate in the US more than elsewhere by virtue of Trumponomics, this does not mean that trade balance would be restored. On the contrary, foreign investors would buy more US assets and bid up the value of the dollar. Imports would rise and hurt disproportionally the manufacturing sector that Trump claims to protect. If the much lower corporate tax rate induces corporations to repatriate profits parked overseas, the move would raise the dollar more, with the conversion of profits held in foreign currencies.

2.3. How will the Fed react to fiscal policy?

In March 2017, the Federal Open Market Committee (FOMC) raised the Fed fund rate in the 0.75%–1% range despite the contradiction between "soft" indicators from financial markets leaning to optimism and "hard" data pointing at mediocre growth in QI (0.5% yoy). It confirmed its stance in June, raising the range to 1%–1.25%. This means that the Fed believes that the gap between the actual rate of employment of the prime age population (25–54 years old), which has reached 78%, and the pre-crisis level (80%) will be closed upwards despite the mixed signals about economic strength, as perceived by the financial markets. However, with the uncertainties raised by the prospective fiscal program, the Fed might be inclined to maintain a cautious approach (Bernanke, 2017). This is the message the Fed seeks to deliver in explaining how carefully it wants to shrink its bond portfolio later in 2017-18.

a larger or faster rise in interest rates than expected cannot be discounted

The size of the fiscal stimulus matters a lot. According to the Fed model, a tax cut of the magnitude of 1% of GDP would push up interest rates by 0.5%. There is also the inflation conundrum; inflation has remained subdued despite low unemployment and low productivity increase. Maybe the FOMC policy makers do not believe that a scenario driven by a large fiscal program is likely, while they are interested in the median path.
The impact of a fiscal stimulus, assuming it will happen, is not easy to assess. On the revenue side of the budget, a large cut in income tax targeted at high-income households could be saved instead of being spent. On the expenditure side, infrastructure programs can take several years to be implemented, whether or not they are launched in tandem with military expenditures. Moreover, the impact of lower business taxes could be mitigated by other policy shifts regarding trade and immigration that might lead to international complications not favorable to investment.
Considering the complex and uncertain economic environment, Fed policymakers are not inclined to depart from their careful stance. Maybe, the buoyant reaction of financial markets to expectations of a strong fiscal stimulus has already sent longer-term interest rates high enough to calm down further disturbance. Nonetheless, a scenario whereby financial markets are taken unawares by a larger or faster rise in interest rates than expected cannot be discounted. This is why a comparison with Reaganomics in the 1980s and recall of the international impact of the 1994 bond market crash are warranted.

3. Are Trumponomics a remake of Reaganomics?

It must be understood from the start that the Reagan period laid down the foundations of a revolution in the American political economy, rather than in economic policy. Reagan absorbed the political philosophy developed by the Chicago School in the inflationary crisis of the 1970s. The paramount belief was that government could not solve major problems: "Government is not the solution, it is the problem". It was the beginning of the neo-liberal era, anchored in the absolute faith in the rationality of market solutions to any problem (Jacob, 1985). This ideology was (and still is) backed by what has been called an epistemic community in the political sciences. This is a huge network of academic institutions that entirely control the main journals and dominate graduate education, instilling a uniform ideology through the media, which penetrates the business and financial communities.
How did Reagan apply this philosophy? He did so through the launch of an economic experiment mixing supply-side economics and monetarism. He overhauled the tax structure in the Economic Recovery Tax Act of 1981, and reduced individual tax rates by 25% over 33 consecutive months. On the expenditure side of the budget, he launched a massive military program, while shrinking federal social spending programs. Meanwhile Paul Volcker, the president of the Board of Governors of the Fed, had just doubled interest rates to kill inflation in a short while. The rationale was that inflation could be reined in without the pain of recession, because rational agents would instantly reduce their inflation expectations, which would be transmitted into the actual inflation rate at full employment.

3.1. The practical legacy of Reaganomics

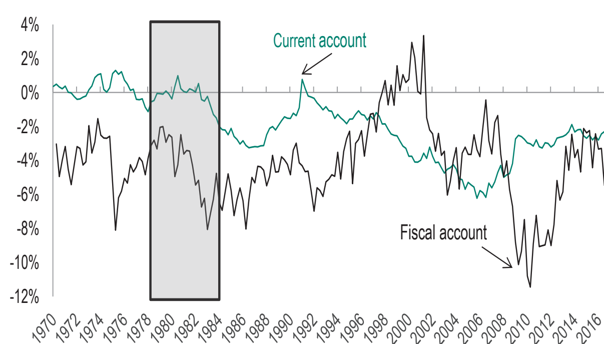
Reagan's economic policy relied on the combination of tax reform, military expenditure and monetarist therapy. Let us recall the credo of the Laffer curve that underpinned tax reform at the time of Reagan's experimentation. Tax cuts should lead to economic miracles in unleashing higher saving and greater work effort, hence boosting investment and productivity. With the benefits of higher growth, the budget would stay balanced and the higher productivity should foster competitiveness, thus achieving trade balance.

The actual results diverged greatly from these promises. Inflation did decline dramatically, from 8.9% in 1981 to 1.1% in 1988. However, this was in complete contradiction with the monetarist doctrine, since the growth in the money aggregate M3 jumped from 6.0% to 16.5% during the same period. With financial deregulation, the oversupply of liquidity was channeled into the funding of speculation on assets' prices, among them the US currency. The effervescence in the stock market led to the 1987 crash. The vertiginous appreciation of the dollar between 1981 and 1985 (40% in real effective terms) required a coordinated intervention by the G10, decided in the Plaza Accord of September 1985, to break it. Less than 18 months later, the Louvre Accord was reached to halt the depreciation of the dollar.

The quick deceleration of inflation was not achieved by virtue of rational expectations, keeping the economy at full employment, but by a deep recession in 1981-82, with unemployment topping 10%. The recession and recovery were standard Keynes: a "heart attack" provoked by the brutal stringency of money, followed by a reanimation of demand through a massive federal deficit, rising military outlays and precipitous cuts in interest rates. Meanwhile, a financial crisis had burst out in Mexico that was going to spread all over Latin America throughout the 1980s, resulting in a lost decade.

As a whole, supply-side economics had a poor record in maintaining fiscal and trade balance (Figure 1). The federal government's deficit jumped from $73.9bn in 1981 to $238bn in 1987 under the weight of cumulative military expenditure. Its debt increased from 33.5% GDP to 50.7% between 1980 and 1986, with a much higher proportion held by foreigners, while the interest paid rose from 8.7% of public expenditure to 16.5%. And the trade deficit exploded from $24.2bn to $169.8bn over the same period.

Figure 1 – Current account and fiscal account in % of GDP



Source: Federal Reserve of Saint Louis, Fred database.

As far as the structure of the economy was concerned, the widening double deficit provoked a flood of capital inflows. Skilled human resources were dragged out of the real economy into finance. This was the beginning of a long productivity slowdown, interrupted temporarily during the Clinton period by the IT wave. It was also the start of the rise in inequality of income and wealth, up to the 2008 financial crisis. These are the macroeconomic results of Reaganomics (Figure 1). The empirical evidence recalled here is enough to repudiate the trickle-down mythology, whose benefits have never been observed anywhere.

3.2. Divergences in economic views

There are striking differences between the Reagan and Trump periods. Reagan was both a dedicated neo-liberal and a seasoned politician. There was no inner contradiction in his political philosophy. Trump is a mix of low-key populist, who wants to "make America great again", and inexperienced politician, who believes that the most powerful country in the world, with a web of international responsibilities, can be run like a business. His constituency consists of people who expect the revival of the old economy; hence his protectionist inclinations, his hostility to environmental commitments, and his indifference to the development of human capital. He has vaguely talked of infrastructure spending, but not of education and health spending in a country where large strata of the population are deprived of the basics of good education, where obesity is widespread, and where life expectancy has actually been declining. Trump is willing to cut public education even more, after repealing Obamacare.

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The most striking differences lay in the area of international relations. Reagan, in connection with Thatcher, was an active propagandist of globalization under US political and military leadership. Trump is acting as if he wanted to disintegrate what is left of the post-war international order. There seems to be no longer a community of shared interests and values in what was called "the West". Trump has already sidelined the US on crucial matters, such as the Paris Agreement on climate change, and has threatened to do the same in relation to international trade treaties.

The outcome is a lack of leadership and of credibility in both domestic and foreign policies, undermining predictability for the next four years. Who knows how much will be done in the area of tax reform, and if there will be a public-spending agenda at all? The result is uncertainty on the economic horizon, which is detrimental to both private firm and household planning.

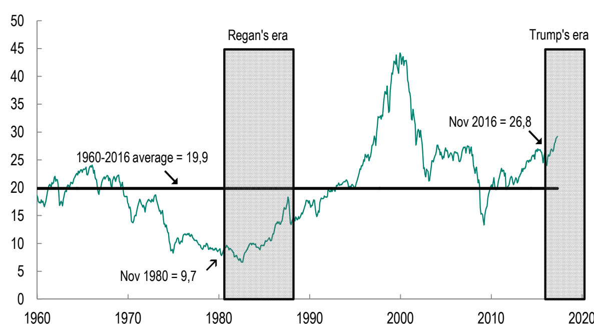
3.3. The supply-side policy and the role of initial environment

The initial economic and financial conditions between the early 1980s and the present time are quite different. The Reagan presidency started just after a "monetarist coup" that had precipitated the country into deep recession. The turnaround in monetary policy ended a long acceleration of inflation that had already plunged financial markets into the doldrums. Trump has acceded to power in a late economic recovery that is unusually long (eight years) and unusually weak, following the 2008-09 systemic crisis. Those disparities show up in the financial conditions at the time of their respective elections.

At the beginning of Reagan's first term, stock prices were particularly cheap in the US compared to their long-term evolution. To see this, we can consider the cyclically adjusted price-earnings ratio (CA PER), calculated by Robert Shiller as the stock price divided by 10-year average earnings for the S&P500 firms (Figure 2). This smoothed PER stood at 9.7 in November 1980, a historical low. Meanwhile, the 10-year Treasury bond exhibited a 12.5% nominal yield, a historical high, leaving room for a large rise in bond prices. Indeed, both markets were on the verge of a long sustained expansion (despite some bubbles and recoveries). In this context, the Reagan administration achieved a four-year expansion, sustained by loose fiscal policy, but also swelling financial wealth, eventually thwarted by the appreciation of the dollar.

In November 2016, the cyclically adjusted price earnings ratio stood at 26.8, well above its long-run average (equal to 19.9, 1960–2016). Furthermore, it has sharply increased since Trump's election, up to 29.2 in April 2017. At this level, there is little to expect from further wealth effect. Similarly, the US bond yields were at a historical low (1.4% for the 10-year Treasury bond) and could hardly get lower. There is nothing to expect but a rise in rates and a decrease in bond market values. Therefore, it is legitimate to wonder how long a Trump-engineered fiscal expansion could last after an eight-year recovery.

Figure 2 – Stock prices in the US, measured by the cyclically adjusted price earnings ratio*



* Stock prices on the S&P500 divided by the companies 10-year moving average earnings.
Source: Robert Shiller homepage.

The danger of a spike in growth, lasting one to two years, followed by a sharp reversal, should be taken seriously, because the debt overhang inherited from the financial crisis has been unequally abated. Mortgage debt has been well tamed thanks to the Fed purchase of mortgage bonds that does not erase the debt since the Fed can and will shrink its bond outstanding. Furthermore, consumer debt has been on the rise, and reached the 2008 peak in QI 2017, although it remains well under its peak in percentage of GDP. The main problem is student debt, which has been growing rapidly in recent years and has reached a delinquency rate of 10%. On the corporate side, companies accounting for 10% of corporate assets are struggling to meet interest payments out of current earnings (IMF, 2017). This means that interest rates are the focal point. Vulnerabilities can easily ramp up in balance sheets if borrowing costs rise. If the policy mix is not carefully managed, this is not farfetched. A rise in interest rates would entail appreciation of the dollar, crushing margins in manufacturing, the sector that Trump claims to care for the most. At that point, the change in mood against Trumponomics could trigger a business downturn.

The danger of a spike in growth, lasting one to two years, followed by a sharp reversal

3.4. Financing the current account

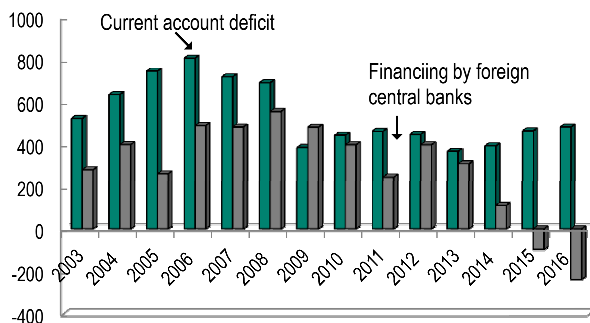
Trump's initial situation is also less favorable regarding the balance of payments. The current account deficit amounted to 2.2% of GDP in 2016, and it has been continuously in deficit for decades, whereas it was in equilibrium at the time Reagan took office (Figure 1). Moreover, from 2003 to 2013, the deficit was painlessly financed with the help of huge purchases of US Treasury bills by foreign central banks from emerging countries. The hoarding of official foreign exchange reserves stemmed from two factors:

(i) the emerging countries' willingness to resist any appreciation in their exchange rate against the dollar in order to protect their trade competitiveness after the string of financial crises, from Mexico in 1995 to Argentina in 2001

(ii) their desire to accumulate a large cushion of foreign exchange reserves in dollars to prevent future currency crises. China played a key role during this period, as it bought enormous quantities of dollars in order to prevent the appreciation of the Renminbi.

Altogether, the central banks' purchases of US assets had a very important impact on the US balance of payments, as it amounted to 73% of the US current deficit on average in the 2003–2013 period (Figure 3). They had the advantage of being inelastic to interest rates, as central banks chose US assets because of the international status of the dollar, not for their yield. The bonanza provided by the purchases of dollars by foreign central banks was strikingly stable, even during the 2008 crisis.

Figure 3 – US current account deficit and the financing by central banks (increase of US assets by foreign central banks), in billions of USD



Source: Bureau of Economic Analysis.

However, the situation has reversed since 2013, once the Fed started to hint at tapering its quantitative easing. Official financial flows are now less favorable for the US. The dollar has been appreciating since this date, and most emerging currencies could not follow its rise. Therefore, emerging economies' central banks stopped buying dollars to avoid the appreciation of their currencies, and, before long, many of them had to sell their dollar reserves to prevent the slide of their exchange rate. In particular, the Chinese devaluation in 2015 put an end to ten years of dollar buying by the PBoC (Chinese central bank). Since then, the PBoC has had to sell dollars to mitigate the depreciating pressures on its currency. Altogether, purchases of dollars by central banks have been completely wiped off and even reversed since 2015. This may make it more difficult to finance a large trade deficit with low interest rates.

4. Trump's shadow over the rest of the world

The most powerful transmission mechanisms from the US economy to the rest of the word lie in financial markets, more specifically in the bond and foreign exchange markets. Opinion has shifted among market participants to the sentiment that the long-run decline in bond yields might be at the point of being reversed. This is crucial because the 10-year US Treasury bond yield is the benchmark of market transactions all over the world. The predominant market opinion is hoping for a gradual rise. However, it is not unanimous. The famous Wall Street forecaster, Henry Kaufman, has written about *"tectonic shifts in financial markets"*. The trend change in bond yields might be bumpy and disruptive for a while. Whether the benchmark 10-year Treasury bond yield rises to 3% at the end of the year 2017 (versus 2.2% on 31 May), indebted companies worldwide would have trouble rolling over their debt. The cost would be magnified for foreign companies whether the rise in US bond yields pushes the dollar upwards or not.

The trend change in bond yields might be bumpy and disruptive for a while.

The belief in a peaceful rise is based on the assumption that growth will remain low, which is tantamount to not believing in the fiscal stimulation promised by Trump. The uncertainty about the path of bond yields vindicates another inroad to history.

4.1. The 1994 bond market crash

Volatility abruptly surged in world bond markets after an unexpected tightening of US monetary policy in February 1994. As usual, higher bond yields were positively correlated with higher volatility and slumping bond prices. International capital flows played a key role, so that volatility increased more in continental Europe than in the US. A 25bp increase in the Fed fund rate led to a 200bp surge in the German Bund rate. In Japan, the bond market was destabilized by exchange-rate movements. The main driver of market spillovers was the behavior of leveraged investors who were forced into fire sales so as to unwind their positions against wrong expectations.

The leveraged investors were part of the shadow banking system: hedge funds and wealthy investors, backed by the big investment banks, trading bonds for extra profits on short-term opportunities. In the last quarter of 1993, they were sure that bond rates would decline mainly in Europe, as the European Monetary System (EMS) – the mechanism then linking exchange rates across European countries – was recovering from a sharp crisis. Massive long positions had been taken in late 1993 on both lower long-term Treasury rates and lower rates in Europe. In February 1994, the Fed raised short-term rates in anticipation of a strengthening economy. The leveraged bondholders were forced to liquidate their positions at fire-sale prices in order to curtail the losses on their portfolios. US bond prices plummeted and bond rates increased by 140bps in the following six months. Spillovers to the mortgage market and to foreign country bonds spread losses to all types of investors in fixed-income markets. When margin calls started to bite, the snowballing liquidation dynamic had lost touch with "fundamentals". Liquidations in Europe were more massive relative to the positions taken, because the resolution of the EMS crisis had just induced a new sense of optimism that was abruptly reversed.

Higher US bond rates were a catalyst for the Mexican crisis starting in December 1994. Mexico was the first victim of the Washington Consensus. From 1991 to 1993, capital inflows had flooded into countries that had begun to be called "emerging market countries". The rise in US Treasury bond yields provoked an appreciation of the dollar, which increased the burden of debt service for all Mexican agents indebted in dollars, mainly the state and the banking system. The capital outflows forced the Mexican government to leave the currency band anchored on the dollar, which resulted in devaluation. Then speculation forced the Mexican government to let the

peso float downwards. In March 1995, the value of the peso halved against the dollar. This was the forerunner of the string of financial crises between 1997 and 2002, from Asia to Russia, and from Brazil to Argentina.

One can say that such a disturbance will not happen again because monetary policy has become much more prudent and transparent in the last few years. However, since the 2008 financial crisis, monetary policy has been confronted with the persistence of a one-way risk (the risk of deflation). Deflation and subpar growth were already downside risks in a political setting where the independence of the Fed was in no way threatened. The present economic and political environment – with tensions between the Trump administration and the Fed, and an uncertain fiscal policy – could generate even more instability.

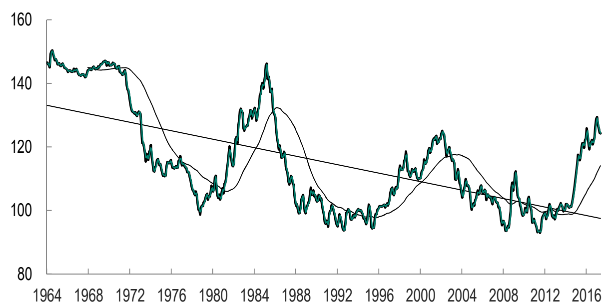
Donald Trump and the Republican majority in Congress have openly criticized Janet Yellen, the Fed chairwoman. Further tensions, not only on macroeconomic policy but also on financial regulation, could reverberate on market volatility. Furthermore, Janet Yellen's mandate is due to be renewed in early 2018. Contrary to the understanding between Reagan and Volcker, operating with a large fiscal leeway at a low ratio of public debt/GDP, the debt/GDP ratio is now at 105%, with disagreements within the Republican majority about the course of fiscal policy. Therefore, there are strong risks that the future course of bond rates will be bumpy. What might be the consequences worldwide?

4.2. How would strong appreciation of the dollar affect the world economy?

For decades, the dollar real exchange rate has been on a sliding trend on the long run, in effective terms, against the main US partners. However, this downward trend has been complemented by wild fluctuations, giving rise to sustained episodes of a substantial increase. Reagan's first term was a case in point of a brutal surge in the USD (about 40% in real effective terms) due to the rise in US interest rates. This episode left bad memories, as it largely contributed to the entrenched US trade deficit and external debt. Currently, we are in the phase of a rising dollar; it gained 23% between May 2013 (first hint of the tapering) and May 2017 (Figure 4). A further increase in interest rates, against expectations, could trigger a further surge.

Unfortunately, the dollar rise still threatens EMEs, whose debt still relies on the US currency, and nearly as much as in the 1990s. The debt building in dollars has been colossal since the 2008 financial crisis, even if there was a short-lived capital flight after Trump's election, followed by a turn-around and a resumption of capital inflows. According to the Bank for International Settlements (BIS), the total debt outstanding in dollars accumulated by non-US-resident, non-financial economic agents, reached $10.5trn, of which $3.6trn was from EMEs. International claims on non-financial agents (securities and bank loans) increased by 3.8% in 2016, while interbank credit has declined continuously since mid-2015. Dollar security issuances accelerated steadily through 2016 (yoy): 4% in QI, 5.9% in QII and 6.2% in QIII. Nonetheless, the ratio of the total debt in foreign currencies to GDP for EMEs as a whole is still less than what prevailed before the Asian crisis. Moreover, the debt is less vulnerable for two reasons: the longer maturity, because the ratio between long-term securities and bank credit is higher, and the much higher cushion in foreign exchange reserves.

Figure 4 – US dollar real effective exchange rate* and trends, index 100=2010



* Relatively to a narrow set of partners.
Source: BIS.

However, in China, the yield on 10-year bonds waxed 250bps in QIV 2016 due to the recent tightening by the authorities in liquidity provision, in order to fight capital outflows and the depreciation of the Renminbi. This provoked a severe disturbance in December 2016, because the purchase of securities by broker dealers was financed by repos on which they were losing money with the fall of collateral asset prices. After the bankruptcy of one of those broker houses, margin calls shot up, forcing fire sales and freezing the wholesale market of security financing for a while. An upward jump occurred in sovereign and high-yield corporate bonds. The market stabilized after the authorities injected liquidities through short-term facilities. However, in another episode of bond market volatility, the chain reaction could spread again.

The global recovery has benefited China by ending the deflation in production prices. It somewhat eases the country's policy of cleaning up debts and taming shadow banking. Nonetheless, Trump's tax plan raises concern with the Chinese authorities because, like a trade war, it could provoke overbids from other countries. Anticipating a massive reduction in the US corporate tax bill, the State Council announced that it would reduce corporate taxes by more than $55bn to improve business competitiveness. The controversy could get very serious, because the World Bank has shown that, in 2016, the total tax burden of Chinese companies amounted to 68% of their profits, against 44% in the US, when all national and local taxes are included. To discourage capital outflows by Chinese companies, motivated by the desire to take advantage of lower

tax rates in other jurisdictions, the government has tightened capital controls. A tax war would be dangerous at a time when both governments need revenues, notably to fund pensions for a rapidly ageing population.

Considering EMEs as a whole, they have been confronted with several disturbances in the international financial markets since the US "taper tantrum" of May 2013 and China's stock market crash of August 2015. In 2015, capital outflows from EMEs reached $735bn. Countries with large current-account deficits and short-term financing in foreign currencies are particularly exposed. A sharp strengthening in the US dollar and a devaluation of the Renminbi could be enough for world production prices to fall back into deflation.

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Recent improvement in EME growth has been due to countries moving out of recession or dampening their recession (Brazil, Russia, Argentina and Venezuela). To keep the recovery going, the relationship between the US and China is paramount and the path of the dollar is the key.

4.3. Can the euro zone keep decoupling from strong dollar appreciation?

The euro area (EA) is different from EMEs. Despite weak remnants, particularly in Italy, its banking system has gotten more robust, as indicated by the present capital ratios relative to risk-weighted assets largely above the Basel III minimum standards. However, subpar growth is protracted, and core inflation is still well under target, which makes a spur in US growth very welcome. A dollar appreciation against the euro would uphold European competitiveness, and a rise in US domestic demand should boost the demand for our exports.

There is a caveat, however. The 1994 bond market disruption showed that international transmission of US expansive shocks can have both a straight economic side and a disturbing financial side. The standard economic repercussions depend on fiscal expansion being moderate, so that the rise in US interest rates is steady and thus anticipated. Uncertainty in the design and implementation of fiscal policy, combined with political bickering with the Federal Reserve, provoked by Trump's behavior, could easily lead to turmoil in financial markets. Holdings of dollar-denominated, long-maturity bonds might register heavy losses: 15% to 20% losses on the outstanding portfolio for an abrupt rise of 2% in the 10-year Treasury bond rate. Losses would be magnified if European bond rates were driven upward, in particular since European bondholders, be they households or institutional investors, hold $3.5trn of bonds at negative interest rates.

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There are even more worrisome possible casualties. Public and private debt sustainability problems might again haunt the EA financial system if the vicious loop between still weak banks, burdened with non-performing loans, and very large public debt reappeared. Italy, with around 130% of GDP public debt and fragile large banks with very low growth and on the verge of deflation, is particularly vulnerable. In its latest Financial Stability Review, the ECB struck the alarm-bell, pointing to reemerging suspicion of sovereign debt unsustainability, amid higher and more volatile long-term interest rates fostered by political uncertainty (Kostka and van Roye, 2017).

For the time being, the ECB indicator of systemic stress in the EA has remained contained thanks to its asset purchase program. Nonetheless, EA bond yields have risen a little due to higher US bond yields. The aggregate EA government debt/GDP has been declining for a while, and is projected to do so in 2017 (90.3%) and 2018 (89.0%) under favorable conditions of pervading recovery. Under the pressure of higher US interest rates, spreads between sovereign bond yields in EA member countries may widen again, putting some already highly indebted countries on an unsustainable path.

Because the European banking union is still incomplete, and because the share of sovereign debt in total banking assets is substantial in some highly indebted countries, a large repricing of sovereign debt would impinge badly on contingent liabilities of the sovereigns to their banking sectors, setting off an adverse feedback loop between bank and sovereign creditworthiness.

Can US monetary policy indirectly trigger such sovereign debt repricing in Europe? Fed officials hinted at their intention to raise short-term interest rates in May, and did so in June. They also announced their intention to shrink their asset holdings later this year by gradually letting the securities mature without reinvesting the proceeds. Both actions are likely to exert an upward pressure on bond yields.

If rates in the EA were to climb 100bps due to the shock caused by rising US rates, this could cost 0.35% in European growth over two years, and cause a dangerous 0.55% decline in inflation over one year, according to the ECB's simulations (Kostka and van Roye, 2017). And, if trust vanishes in the financial markets, as in 1994, self-fulfilling processes across international financial markets would be magnified. As a consequence, the losses occurred by institutional investors on their bonds could curtail their participation in the Juncker Plan, precluding the much-needed long-term investment to be achieved in the relevant amount. Overall, the ECB might have to change course to keep interest rates in Europe as low as possible.

5. Conclusion

Trump's election has opened up a new period of uncertainty in geopolitics. It has critically weakened what remained of the post-world-war order. Deep uncertainty prevails. Difficult questions arise in the US: How strong is the populist wave that propelled Trump to power? How will the social divide affect the future course of economic policy? We have pointed to fiscal policy as the critical spot for two reasons. First, it is the ground for serious divergences within the Republican Party. Second, it can feed lingering controversies with the Fed, or worse, result in attempts by the president to dilute the Fed's independence, taking the opportunity of the renewal of the Fed's chair early next year. A combination of both of the above might easily wreak havoc in the financial markets, sparking bursts of volatility in bond and exchange-rate markets that are crucial to the rest of the world.

Geopolitical rivalries might provoke financial turbulence because they could intensify stress in the international financial community, given the high level of dollar-denominated debt in several emerging-market countries. A steep rise in the dollar could be the catalyst if the higher balance-sheet risks of debtors triggered heavy capital outflows. In the highly interconnected international financial system, contagion can arise again.

Furthermore, a moment of truth has come for Europe. Trump's decision to withdraw from the Paris Accord on climate change is dramatic, since the latter is the paramount problem that human civilization has to tackle in this century. It requires a response by the international community in which Europe can and must take the lead. Long-standing investments are more pressing than ever as the cement for renewed cooperation within Europe to match environmental commitments and potential growth in a model of sustainable development. In doing this, Europe must form new alliances with the emerging market countries, particularly by sealing a pact with China and India to prolong and amplify the commitments of COP21.

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