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Trump’s tax and trade policies could hurt Australia and the world

HENRY ERGAS THE AUSTRALIAN 12:00AM November 21, 2016

Having promised to return manufacturing jobs to the US, Donald Trump’s macroeconomic policies may instead accelerate their demise.

Were that to occur, the protectionist backlash could become even more ferocious, provoking trade wars that would be enormously costly for Australia and the world.

At the heart of Trump’s program are sweeping cuts in personal and corporate taxes. Reducing taxes makes good sense; but the impact of Trump’s tax cuts on government revenues would be substantial, with the nonpartisan Tax Foundation estimating receipts would be some $US5.4 trillion lower over a 10-year period.

Indeed, even accounting for the higher growth the tax reductions would bring, the Tax Foundation finds that the fall in receipts would still be in the order of $US3.4 trillion.

And the Trump tax cuts don’t end there, as the president-elect’s $US1 trillion infrastructure plan will apparently be financed through new tax credits, whose costs are not included in the Tax Foundation’s estimates.

Those declines in revenues aren’t matched by expenditure cuts: on the contrary, many outlays are set to rise. In defence, Trump has supported a 350-ship navy, which, the Congressional Budget Office estimates, would add $US120 billion to projected outlays, along with expansions in the army, the air force and the marines that would cost nearly as much.

To fund those plans, the Trump camp has called for non-defence outlays to be trimmed by 1 per cent a year. So far, however, it has provided no detail as to where the axe would fall. And the guarantees Trump gave about protecting major spending programs make it impossible to reduce expenditures by the amount needed to prevent a burgeoning budget deficit.

Trump’s tax cuts would therefore deliver a large fiscal stimulus. But unlike

2009, the US economy is near or at full capacity. And with the latest data showing strong housing starts and retail sales, while the number of new unemployment insurance claims has dropped to its lowest level since 1973, the Federal Reserve seems certain to raise its benchmark federal funds rate at its December meeting.

As a result, fiscal policy, which is somewhat expansionary, will become vastly more so, just as monetary policy is tightened. The effects are predictable: as US interest rates rise relative to those elsewhere and foreign savings flow into the US to finance the budget deficit, the US dollar will strengthen, much as the Australian dollar did in the wake of former prime minister Kevin Rudd's stimulus spending.

In fact, as markets anticipate what lies ahead, those effects are already playing themselves out: with the gap between US and German government bond yields greater than at any time since 1989, the ICE Dollar Index, which measures the US currency relative to six others, has reached its highest level in 13 years, rising by 2.9 per cent since the election.

Even before that increase, the Peterson Institute for International Economics estimated that the US dollar was overvalued by 7 per cent, pushing the current account deficit — the balance on all inflows and outflows of trade and investment income — from 2.7 per cent of gross domestic product in 2015 towards 4.1 per cent of GDP by 2021, which is more than twice its long run average.

The dollar's further rise will only accelerate the deterioration, with a sizeable part of the fall in the current account balance likely to come from increased imports of manufactured goods.

This is hardly the first time that has happened. Rather, experience has repeatedly shown the devastating effects of large, unfunded, tax cuts on US competitiveness.

Never were those effects clearer than in the early 1980s, when the combination of a tight monetary policy associated with Federal Reserve chairman Paul Volcker and an expansionary fiscal policy associated with president Ronald Reagan increased long-term interest rates, attracting capital inflows that drove the currency to a 40-year peak.

Equally, the tax cuts initiated by president George W. Bush were ultimately funded by foreign purchases of US government bonds, propping up the dollar and worsening American manufacturing's decline.

As Jeff Shafer, a former undersecretary of the US Treasury for international affairs, has argued, those exchange rate effects — which are symptoms of poor domestic policy settings — have swamped other factors in distorting the American economy, shrinking the traded goods sector and shifting resources into services (and in the lead-up to the financial crisis, housing). Yes, trade agreements played a part; but their impacts would have been more gradual and balanced had macroeconomic policies been on a sustainable footing.

Of course, congress could oppose cutting taxes without offsetting spending reductions. But although Kevin Brady, the Republican chairman of the House of Representatives' tax-writing committee, said last week that the tax overhaul would "aim" not to increase the deficit, all the signs point the other way. Having already loosened fiscal policy in last year's budget, US legislators, like those in an ever-growing list of countries, have effectively consigned deficit reduction to the "too hard" basket, partly because government ability to borrow at extremely low rates makes debt accumulation seem a painless option.

The pain a surging dollar causes in the Rust Belt states will, however, be all too real. And as that pain makes itself felt, it will be harder and harder for Trump to back away from the anti-trade rhetoric that dominated his campaign, with China — whose currency is weakening because of capital flight — squarely in the protectionists' sights. Reagan was a committed free trader who worked hard to contain cries for protection when the trade balance soured; Trump is not.

The risks that poses for Australia are obvious. Already now, the world is hardly in great shape. With the inauguration just 60 days away, expect it to get uglier.