**Global economic challenges for Donald Trump

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Panel, Monday, December 5, 2016 | 10:00 am - 12:00 pm

**American Enterprise Institute, 1789 Massachusetts Ave, Washington, DC**

* Quadrennial panels offer “Advice for the new Administration”
	+ I feel the need this year to acknowledge that advice from us “experts” and “elites” is unwanted by Mr. Trump and his supporters.
		- Just to show that we understand.
	+ That said, the Trump Administration will encounter international events and constraints that it did not figure on in the campaign,
	+ a common pattern, though much more extreme this time.
* Of course international trade, the US trade deficit, and the Chinese exchange rate were big issues in the campaign
	+ Let’s start with his promise immediately to name China a manipulator of its currency.
		- Mr. Trump might have to confront the reality that if China moved to a freely market-determined exchange rate as he and other US politicians have been asking, the RMB would get weaker, not stronger.
			* For more than two years, the PBoC has been intervening to fight RMB depreciation, not to encourage it.
				+ It has sold dollars and bought RMB, not the other way around.
				[graph]
			* Similarly, Chinese authorities have recently tightened controls on capital outflows, not inflows.
		- A weaker RMB would of course help China’s net exports to the US, not reduce them.
* The US trade balance
	+ [Little-known fact:] The US trade deficit as a share of GDP has been narrowing for the last 10 years [graph]
	+ Mr. Trump’s policies are likely to set the trade deficit back on a deteriorating path
		- even if he doesn’t stop China from intervening in the foreign exchange market.
		- But does go ahead with what seem to be his fiscal plans.
	+ I refer to plans for massive tax cuts and big increases in spending (including military and infrastructure investment).
		- It is hard to predict what the carryover will be from statements in the campaign to actual policies.
		- But Congress is likely to support this sort of fiscal expansion.
		- Repeats of what Ronald Reagan and George W. Bush did.
	+ The budget deficit will reduce national savings which would worsen the current account deficit.
		- An example of the “twin deficits” that we saw under Reagan and Bush.
* Through what causal channel would the trade balance worsen?
	+ First, the fiscal expansion will put upward pressure on interest rates, especially since we are already essentially at full employment.
		- Of course the Fed had already been expected to raise interest rates Dec.14.
		- Recent developments augur more interest rate hikes in 2017 and 2018.
		- The new Administration will probably oppose the increases
			* Notwithstanding that during the campaign the candidate attacked the Fed for keeping interest rates too low.
			* Hopefully the Fed’s independence will hold, as it did under Volcker.
	+ It will also put upward pressure on the dollar.
		- Because higher interest rates attract a capital inflow,
			* as in the classic Mundell-Fleming model :
			* BD ↑ => NS↓ => i rate ↑ => $ ↑ => TD↑
		- Mr. Trump is doing more to depreciate other currencies against the $ than currency manipulation does.
	+ Indeed the increases in US interest rates and the value of the dollar have already gotten underway, ever since the election. [graph]
* “How does the importance of free trade fit in and can the US continue its leadership in promoting trade?
	+ In the long run, a reversal of US-led globalization will do damage both to our economy and to our geopolitical position.
	+ Would a sharp increase in import tariffs, even if inconsistent with our international obligations improve the trade balance?
		- Possibly, in the short term.
		- But the fall in imports is likely to be offset by a fall in exports.
			* If Mexicans’ income falls, their imports from us will fall.
			* If our inputs of labor intensive auto parts from Mexico fall, our exports of finished autos are likely to fall.
			* If Mexico retaliates against our tariffs by raising its own, as it is entitled to do, our exports to it will fall.
	+ The net effect on the trade balance depends on the macroeconomic factors already considered: a fiscal expansion is likely to worsen the trade balance.