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FX Insights

FOREIGN EXCHANGE

The weak dollar revolution could be tweeted

"My administration will follow two simple rules: Buy American and hire American…"
(Trump tweet, 29 December 2016)

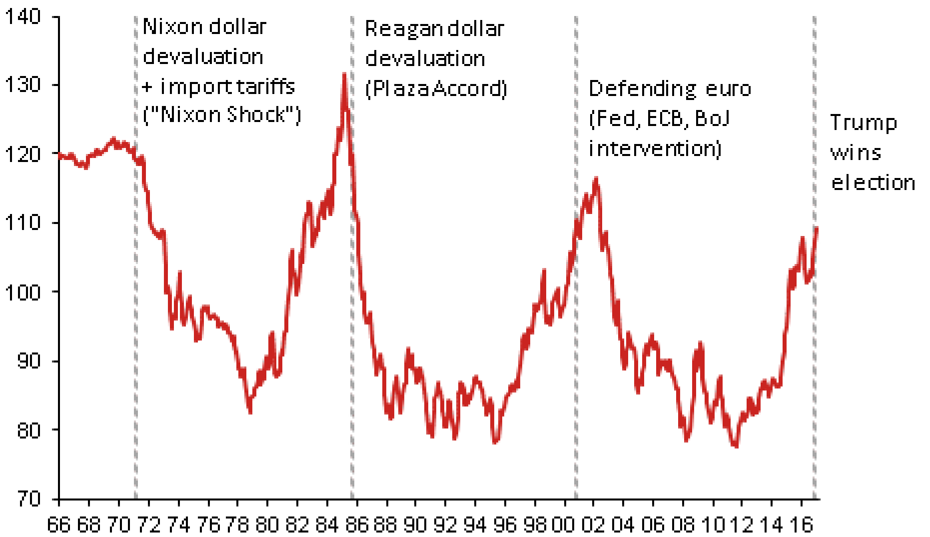
"Today, we import nearly $800 billion more in goods than we export. This is not some natural disaster. It is politician-made disaster. It is the consequence of a leadership class that worships globalism over Americanism. This is a direct affront to our Founding Fathers, who wanted America to be strong, independent and free. … The first Republican President, Abraham Lincoln, warned that: 'The abandonment of the protective policy by the American government... must produce want and ruin among our people.'…Yet today, 240 years after the Revolution, we have turned things completely upside-down."
(Donald J. Trump Address: Declaring American Economic Independence, 28 June 2016)

Some have criticised Donald Trump for his lack of policy detail, but the one area where he has had a consistent message and policy proposals has been international trade. His talk of renegotiating trade treaties and threat of import tariffs is decidedly protectionist. This is all the more surprising as it runs against the conventional Republican stance and is more in line with mainstream Democrats. If implemented, this would signal one of the largest reversals in US bipartisan policy in decades. A less-discussed but natural extension of a protectionist stance would be a weak dollar policy.

Trump is overturning Republican orthodoxy

The Trans-Pacific Partnership (TPP) – a trade agreement between 12 Asian countries (excluding China) and the US, which Donald Trump so clearly opposed, was always more supported by Republicans than Democrats. In 2015, on a vote in the House of Representatives to fast-track the ratification of TPP, President Obama required the Republicans to carry the vote. 80% of Republicans voted in favour while 75% of Democrats voted against. Among those voting in favour were Paul Ryan (House Speaker) and soon-to-be Health Secretary, Tom Price.

Fig. 1: US FX policy intervention around previous dollar peaks
real narrow effective exchange rate



Source: Federal Reserve Board, BIS (pre-1973)

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Some of the most vocal critics were luminaries of the left, from Noam Chomsky *("[TPP is] designed to carry forward the neoliberal project to maximise profit and domination"*[1]) to Bernie Sanders *("we need to defeat this treaty and fundamentally rewrite our trade policies to create good-paying jobs in this country and throughout the world and end the race to the bottom")*[2].

Moreover, Mr Trump's pointed attacks on China, calling it a mistake on the part of the US to allow China to join the WTO[3], was in many ways a product of Republican policy. Like TPP, it took the Republicans in Congress to pass Bill Clinton's proposal to grant China Permanent Normal Trading Rights (a precursor to WTO ascension) in 2000. In the House of Representatives, three-quarters of Republicans supported it, while two-thirds of Democrats voted against it. Following his election, Republican President George W. Bush went on to state: "I'm an advocate of China's entry into the WTO"[4]. Yet Donald Trump at the time stated: "I would say generally speaking repeal it [China's Permanent Normal Trading Rights]"[5]. That was a time when he was pro-choice[6] and proposing a 14.25% wealth tax[7].

Throughout the years then, Donald Trump's one consistent policy has been a protectionist or "fair trade" policy. To some it may be odd to associate the Republican Party with protectionism, but before the Second World War it was the Republicans that were traditionally protectionist, while the Democrats were advocates of free trade. Indeed, the founder of the Republican Party, Abraham Lincoln was a protectionist, who in turn was following the tradition of protectionism all the way back to some of the Founding Fathers. Moreover, with the rise of China, the US no longer dominates the international economic system it set up after the Second World War. Therefore a realignment of the Republican Party to its pre-war roots is more plausible.

The most obvious manifestation of this would be the renegotiation of existing trade agreements, and it could even include imposing import tariffs. The natural extension of this would be the introduction of a weak dollar policy. It would stop a strong dollar from offsetting the effects of any import tariffs or reducing the competitiveness of US exporters. Emerging markets have also employed such tactics. The dollar is also trading at its highest level in 15 years (Figure 1). Therefore, early in the Trump administration we could see the introduction of some form of weak dollar policy.

Trump's detailed plans on trade

In Donald Trump's most detailed elaboration of his trade policy made in June 2016 he laid out his "7 Point Plan to Rebuild the American Economy by Fighting for Free Trade":

1. Withdraw from TPP.
2. Appoint smart trade negotiators.
3. Identify every violation of trade agreements and use every tool under American and international law to end these abuses.
4. Tell NAFTA partners that we intend to immediately renegotiate the terms of that agreement to get a better deal for our workers.
5. Instruct the Treasury Secretary to label China a currency manipulator.
6. Instruct the US Trade Representative to bring trade cases against China, both in this country and at the WTO.
7. Use every lawful presidential power to remedy trade disputes if China does not stop its illegal activities, including its theft of American trade secrets – including the application of tariffs consistent with Section 201 and 301 of the Trade Act of 1974 and Section 232 of the Trade Expansion Act of 1962.

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1 He also said: It's called free trade, but that's just a joke… These are extreme, highly protectionist measures designed to undermine freedom of trade. In fact, much of what's leaked about the TPP indicates that it's not about trade at all, it's about investor rights." (13 January, 2014, *Huffington Post*)

2 "Sanders Welcome McConnell Decision to Block TPP", 26 August 2016, sanders.senate.gov

3 Donald J Trump Address: Declaring American Economic Independence, 28 June 2016

4 "Bush backs China's WTO entry despite standoff", 6 April 2001, CNN

5 Donald Trump on "Meet the Press", NBC, 24 October 1999

6 ibid.

7 "Trump proposes massive one-time tax on the rich", CNN, 9 November 1999

One of the most remarkable aspects of his plan is the level of detail and the citation of US Acts of law that could be invoked. In no other areas of policy has he done this.

The power to impose import tariffs

In terms of the specifics, sections 201 and 301 of the Trade Act 1974 and Section 232 of the Trade Expansion Act of 1962 allow the President to impose tariffs on imports from foreign countries without having to get congressional approval. There are some potential constraints such the need to demonstrate "injury" from import competition or that foreign countries are engaging in discriminatory practices against the US. However, these could easily be overcome[8].

Mr Trump could obtain more sweeping powers by invoking the Trading with the Enemy Act (TWEA) of 1917 or the International Emergency Economic Powers Act of 1977. They give the President almost unlimited powers to impose tariffs or quotas on imports during war or a national emergency. Defining either is not straightforward, however, and Presidents have exploited that ambiguity. President Roosevelt used the TWEA in 1933 to introduce a bank holiday and President Nixon used the Act to impose a 10% imports surcharge during the "Nixon Shock" of 1971.

Then there are the Republican tax reform proposals which introduce a form of import tariffs. This would be introducing border adjustments, which would stop US exports from being taxed, while not allowing imports to be tax deductible. This would be part of a sweeping change in the US corporate tax towards a destination-based tax system, which means that corporate taxes are only applied to sales made in the US. The upshot is that, if implemented, within a year or two over $100bn could be raised from these border taxes. This would equate to a rough 10% tax on imports. However, unlike the Acts mentioned above, these would require Congressional approval.

Weak dollar policy is a natural extension of protectionist policies

Clearly, the one area of trade policy that has been so far little discussed is FX policy. In a detailed interview on 30 November 2016, soon-to-be Treasury Secretary Steve Mnuchin evaded a pointed question on whether he supports a strong dollar. Instead, he responded:

"I think we're really going to be focused on economic growth and creating jobs and that's really going to be the priority." (CNBC, 30 November 2016).

FX policy cannot be ignored in trade policy. A weak currency can be effective in giving domestic industries an advantage over foreign industries. Indeed, this has generally been the policy of emerging Asia economies from China to Thailand. Their substantial growth in FX reserves since the Asia crisis in 1997 is testament to a concerted policy to curb strength in their currencies. For Donald Trump, at a fundamental level, any appreciation of the dollar would offset some if not all of any import tariffs introduced.

As for the practicalities of introducing a weak dollar policy, the Plaza Accord of 1985 under a Republican administration is the last such example. However, it was co-ordinated with key trade partners and monetary policy was moving in a supportive direction. Replicating such an Accord would be a gargantuan task. The other precedent of sorts is the Nixon shock – again under a Republican administration. This was a unilateral move and involved both a currency devaluation and the imposition of import tariffs.

However, the better reference points may actually be emerging markets. They have pursued weak currency policies without co-ordination and often at odds with domestic monetary policy. Admittedly, the presence of capital controls makes it easier to separate FX and monetary policy (thereby overcoming the so-called Triffin dilemma).

The success of their policies has often hinged on the scale of their interventions whether through direct currency intervention or sovereign wealth fund purchases of foreign assets. One study featuring 133 countries over the past 30 years found that such state-directed outflows were a significant positive driver of the current account (i.e. pushed it into surplus)[9]. An IMF study featuring 52 countries (13 advanced and 39 emerging) from

8 See "Assessing Trade Agendas in the US Presidential Campaign" (Noland, Hufbauer, Robinson, Moran, Peterson Institute For International Economics, September 2016).

9 "Foreign Exchange Intervention Since Plaza: The Need for the Global Currency Rules" (Gagnon, 2015).

1996 to 2013 found that currency intervention had a larger and more significant impact on exchange rates than interest rate differentials[10].

It should be noted that Japan, which has been the most active G7 intervener in currency markets, has typically engaged in sterilised intervention. That is, intervention that would not affect domestic money supply (and so not impact monetary policy). Studies have shown that Japanese intervention has at times been successful even though it was sterilised. Moreover, one study by former Deputy Vice Minister of Finance for International Affairs, Taktatoshi Ito, showed that FX intervention over the 1990s, which was predominantly uncoordinated with other countries, resulted in a profit of JPY9 trillion ($75 billion). This showed that the MoF was buying USD/JPY at the lows and selling at the highs[11]. Therefore, there could be nothing to stop the US engaging in FX intervention to weaken the dollar.

Corporate tax changes not likely to see surge in capital inflows

One headwind for a weak dollar policy could be any capital inflows induced by Donald Trump's tax policy. The most obvious Trump policy in this area is a tax amnesty on US companies repatriating offshore cash holdings.

Back in 2005, this saw significant inflows into the US and the dollar strengthen. However, we estimate that the bulk of US corporate earnings accumulated since then is held in dollars and much of it will be kept offshore for foreign investment. Of the $3 trillion of accumulated offshore earnings, we estimate that 30% is in foreign currency and that only 15% will be brought back to the US. As a result, repatriation will likely have a marginal impact on the dollar[12]. Moreover, data from US companies that have disclosed the foreign currency split in their overseas cash holdings suggest our estimates of foreign currency holdings are on the high side[13].

The more subtle influence could be any changes in the corporate and investment tax rates. The Taxpayer Relief Act of 1997 under President Clinton is thought to have partly made the US current account more sensitive to productivity shocks and changes in the dollar. The Act reduced capital gains tax, which in turn meant that higher equity prices would lead to greater wealth gains. This would lead to higher consumption, higher imports and a larger current account deficit. From 1997, a given change in the dollar doubled the impact on the current account[14]. Of course, the tax change wasn't the only factor for this change; the Asia crisis of that year saw a major change in the management of FX regimes across Asia, which impacts these relationships.

Another tax change that had an impact was the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JCTRRA) under President Bush. This was a comprehensive change in taxes on individuals, capital gains, dividends and estates. The change in dividend taxes was instructive. They were lowered to 15% for American equities and a subset of foreign countries (treaty countries), while remain unchanged for the remaining foreign countries. The tax change saw US equity flows to the average treaty country rise by 90% compared with those to the average non-treaty country[15].

Donald Trump has advocated cutting income and corporate taxes and eliminating inheritance taxes. The corporate tax rate would be cut from 35% to 15%. Part of the rationale is that the headline 35% rate is one of the highest in the developed world. However, in practice given current deductions, the effective corporate tax rate is closer to 27%, which puts it slightly below the OECD average[16].

Mr Trump's full tax plans, which include changing deductions as well as cutting the headline tax rate, would push down the effective corporate tax rate to 25% – not quite as dramatic as initially expected. Moreover, in 2009 during President Obama's first calendar year in power, the effective tax rate fell to 20% (Figure 2). Despite that decline in the tax

10 "Unveiling the Effects of Foreign Exchange Intervention: A Panel Approach" (Adler, Lisack and Mano, IMF, 2015)

11 "Is Foreign Exchange Intervention Effective? The Japanese Experience In the 1990s" (Ito, 2002)

12 For more see Nomura's "HIA is on the table again" (Charles St Arnaud, 9 November 2016)

13 In its 2016 annual report, Microsoft indicates that only 8% of its $109bn overseas cash holdings are in foreign currencies.

14 "A Threshold Model of the US Current Account" (Duncan, 2014)

15 "Dividend Taxes and International Portfolio Choice" (Desai and Dharmapala, 2009)

16 "International Corporate Tax Rate Comparisons and Policy Implications" (Gravelle, Congressional Research Service, 2014)

rate, the dollar fell that year as the Fed's QE programme dominated any corporate-tax-induced capital inflows to the US. So leaving aside any possible delays in implementing changes in the US tax system, the proposed changes to corporate taxes aren't as large as the headline cuts would suggest.

The 1944-2008 US-dominated world economic order

There is little doubt that President-elect Donald Trump will look at protectionist tools including a weak dollar policy. However, the challenge is to square this with Republican orthodoxy. This can be resolved by reviewing Republican policy over a longer stretch of time. Indeed, the post-war period up to 2008 may have been the aberration, when the US as the dominant economic power was able to ensure the international economic arrangement was geared to its own interests. Free trade was then a means to gain access to otherwise closed foreign markets. Britain employed the same strategy when it was the dominant economic power in the nineteenth century. It extolled the virtues of free trade and used that as a means to access markets in Asia from India to China.

The US-centred system was set up in 1944 in the form of the Bretton Woods arrangement. Among its key features was the idea that major economies would now link their currencies to the US dollar, rather than gold. The dollar in turn was tied to gold, but importantly the direct link was to the dollar – a departure from the pre-war period. The exchange rates of these countries would maintained around a +/-1% rate against the dollar. The IMF and World Bank were set up to help ensure such a system was sustainable with the US being the dominant partner in each organisation. Other organisations such GATT (later WTO) and BIS were also established to set trade rules and banking standards.

The primacy of US interests became evident in the late 1960s when the US started to run twin deficits partly in response to the escalating costs of the Vietnam War and partly as Japan and Germany were exporting much more. To stop gold reserves from being drained away, the US would need to implement deflationary policies to narrow its trade deficit. However, rather than this, in 1971 President Nixon decided to suspend convertibility of the dollar to gold – effectively ending the Bretton Wood FX regime. Also for the first time since the War, he imposed a blanket 10% import tax.

Fig. 2: Obama's first term saw a lower corporate tax rate than Trump's proposal
effective rate

Source: "An analysis of Donald Trump's Tax Plan" (Nunn et al, Dec 2015), Bloomberg

Even though the US "broke" the system, the subsequent floating exchange rate system for Europe, Japan and the US saw the dollar as the reference currency and as a result was the clear reserve currency. In the new regime, the US and UK were the first to liberalise their capital accounts in order to establish themselves as financial centres. The rest of Europe followed a slower path and had the intention of greater regional integration[17]. With the election of Ronald Reagan in the US, a clearer free-market

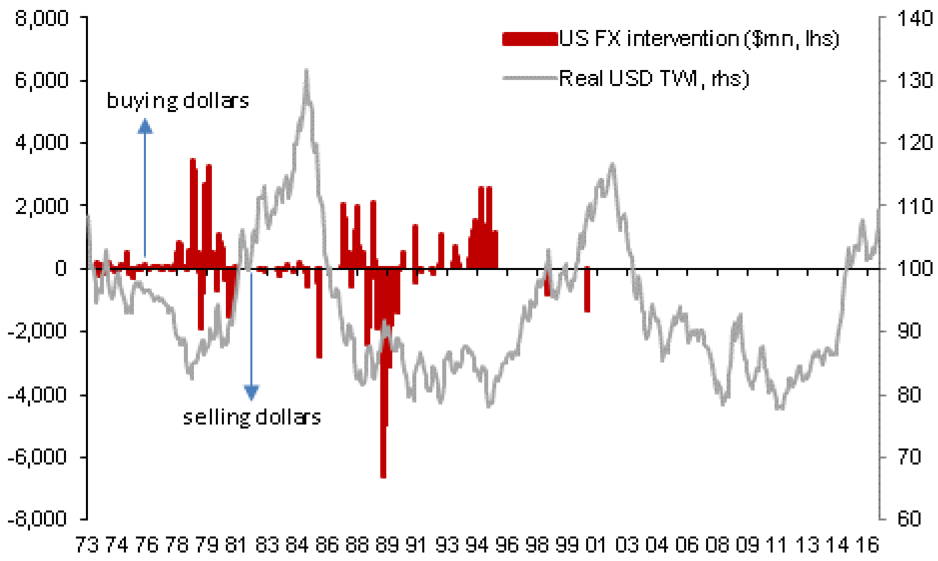
17 "Short Run Pain, Long-Run Gain: The Effects of Financial Liberalisation" (Kaminsky and Schmukler, 2003)

ideology developed which encouraged other countries including emerging markets to open their capital accounts.

One aberration in the *laissez-faire* post-Bretton era was the Plaza Accord in 1985 under the Reagan administration. Between late 1980 and early 1985 the dollar had risen 50% against its major trading partners. Initially, the US persuaded the Japanese to enter voluntary export restraints where they limited the export of Japanese cars to the US. Later the US imposed imports tariffs on Japanese semiconductors and motorcycles. But the march of the dollar saw US companies continuing to clamour for additional protectionist measures to help regain competitiveness in the export market. By 1985, the US current account deficit had reached over 3%. Countries like Germany were concerned with the inflationary pressures of a weak Deutschmark, while Japan wanted to maintain stability of its currency rather than see it at extremes.

This eventually led to the famous Plaza Accord in September 1985, when the US, Germany, Japan, UK and France agreed to intervene in FX markets to bring the dollar down[18]. The coordinated intervention was successful as the dollar fell 40% over the next two years (Figure 3). It helped that the dollar surged 17% from mid-1984 to mid-1985 and so was out-of-line with underlying currency fundamentals[19].

Fig. 3: US FX interventions since 1973



Source: Federal Reserve Board, Bloomberg

The 2008 crisis and the rise of China have disrupted the system

However, the financial crisis of 2008 has disrupted this system. Not only has it questioned the economic model of the US, but it has been accompanied by the continued rise of China. Today China is the second largest economy in the world in nominal terms. Adjusting for the level of prices and ignoring fluctuations in foreign exchange rates, China overtook the US in 2013 as the largest economy in the world. Extrapolating IMF projections, in less than ten years China will overtake the US as the largest economy in nominal terms. Importantly, it has grown outside of the US zones of influence which saw Japan, Germany, Taiwan and Korea grow into advanced economies.

Since 2008, China has asserted itself on the prevailing international system. The clearest manifestation of the shift in the global order has been the emergence since 2008 of the G20 forum, which includes China, as the main platform for policymakers to discuss global issues rather than the G7. It was the G20 that issued the 2009 statement laying out the new architecture of the global financial system, which included shifting OTC

18 See "Announcement the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom, and the United States (Plaza Accord)", September 22, 1985

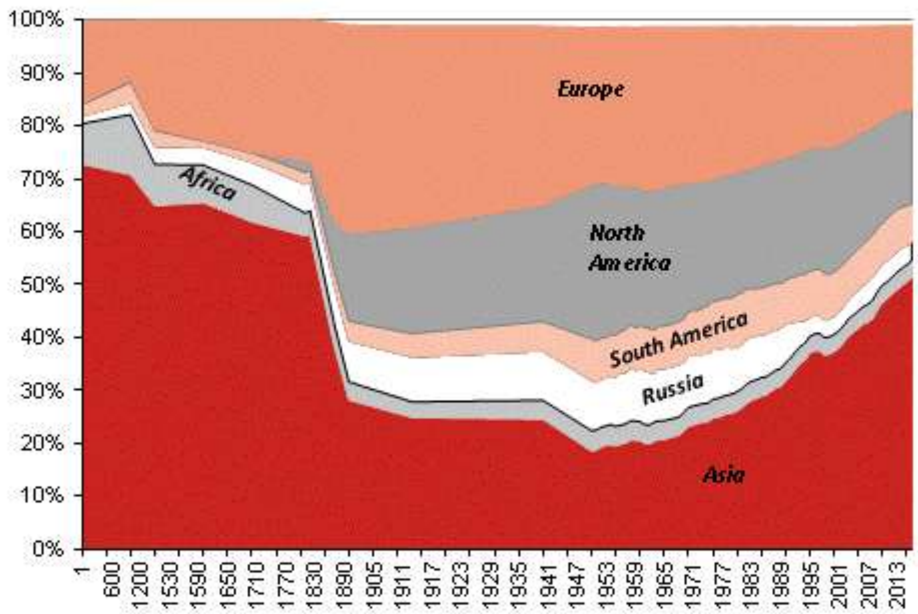
19 By 1987, the decline of the dollar was thought to have been excessive and the same policymakers reconvened to set a new stabilisation policy, which was called the Louvre Accord. The period 1985-87 likely marked the heyday of US-led co-ordinated FX policy. There were subsequent mini-interventions in 1995 by the Americans to push the dollar higher, in 2000 by the Europeans to arrest the decline in the euro, and in 2011 by the Japanese to limit yen strength after the tsunami.

derivatives to exchanges and is centrally cleared. China gained membership of the Financial Stability Board which was formed in 2009 to monitor the global financial system. In 2015, it increased its voting share at the IMF from 3.8% to 6.2%, and in 2016 the Chinese yuan was included in the IMF's global currency unit, the SDR, which had previously only included the US dollar, euro, British pound, and Japanese yen.

Not only that, but China has also set up its own versions of the Bretton Wood organisations. Its version of the IMF is the Contingent Reserve Arrangement (CRA) and its version of the World Bank is the Asian Infrastructure Investment Bank (AIIB).

In some ways, this is simply a reversion to mean. Historically, Asia led by China was the dominant economic power in the world (Figure 4). China was close to a fully-fledged industrial revolution in the twelfth century. A series of reforms culminating in an imperial decree of 1153 effectively ended the possibility of serfdom as peasants could secure their own tenancies and there was a relatively free market in land. By the early 1100s, China produced more cast iron than Britain did in the late 1700s. Iron production was more than double what Britain was able produce on the eve of its industrial revolution 600 years later in 1788. Industrialists used coke blast furnaces, mechanical spinning machines for hemp and magnetism. Meanwhile, farmers had developed early-ripening rice. In the financial sector, cheques, paper money, and bills of exchange were all used.

Fig. 4: Distribution of world economy from 1 CE to 2016



Source: The Maddison-Project, http://www.ggdc.net/maddison/maddison-project/home.htm, 2013 version, IMF

What stopped China fully industrialising? First, the Jurchen who inhabited Manchuria invaded and captured north China from the ruling Sung. This isolated the agricultural south from the iron-producing north. Then the Mongol invasion decimated the Chinese empire in the early 1200s. By 1300, the Chinese population had fallen by more than a quarter compared with a century earlier, and it fell further that century due to plague and disease[20].

Need history to learn about US policy when not the global hegemon

The current rebalancing of power away from the US necessitates a look back at history when the US was not the dominant economic power. Indeed, that period may well be providing inspiration for Donald Trump's policies on trade.

Going back to the time of the Founding Fathers, the US was clearly an emerging market. At the time of its independence in 1776, the US economy was only one-third the size of the British or French economies. The British didn't even see its defeat in the American Revolution as the end of its hegemony. The British were willing to agree generous terms for the Americans in the Treaty of Paris in order for it to be a major trading partner for

20 Chapter 13, "World History: A New Perspective" (Ponting, 2000)

Britain. Britain then re-oriented its ambitions to the east, where it asserted more control over India and Australia.

But the biggest economy at the time of the Founding Fathers was neither the British nor the French; it was the Chinese. China's economy was 20 times that of the US. Under Emperor Qianlong, China's territory reached its largest in history. The self-confidence of the Chinese was evident in a response to a 1793 letter from the British King George III requesting a British presence in mainland China:

"You, O King, live beyond the confines of many seas, nevertheless, impelled by your humble desire to partake of the benefits of our civilisation … Our dynasty's majestic virtue has penetrated unto every country under Heaven, and Kings of all nations have offered their costly tribute by land and sea. As your Ambassador can see for himself, we possess all things. I set no value on objects strange or ingenious, and have no use for your country's manufactures. This then is my answer to your request to appoint a representative at my Court."

Early US trade policy

It is instructive how the US viewed trade policy when it was an emerging market. While import tariffs had to be imposed as there were no other major sources of tax revenues (income tax would come later), there was a debate among the Founding Fathers about whether to use them to protect domestic industry or not. On one side, Thomas Jefferson argued that it should just cover government expenditures. He was also considering the interests of southern states which were agrarian importers. On the other side was Alexander Hamilton, who argued for higher import tariffs to protect US industries. He had an eye on the interests of the northern states which were manufacturing exporters.

Alexander Hamilton outlined his views in his "Report of Manufactures" which was presented to Congress in 1791. He argued that to maintain American independence, it needed a strong manufacturing sector. This could be achieved through subsidies to industries and tariffs on imports. The report would turn out to be hugely influential in later American politics, particularly on the forerunner to the Republican Party, the Whig Party and later on Abraham Lincoln.

However, the early years of an independent US saw a compromise between these perspectives in the first Tariff Act of 1789:

"Whereas it is necessary for that support of government, for the discharge of the debts of the United States, and the encouragement and protection of manufactures, that duties be laid on goods, wares and merchandise."

While it did reference protection of domestic industry, provisions to limit British imports were not accepted. Crucially, it did place the authority to set import tariffs with the Federal government rather than the states.

The US war against Britain and the Native Americans from 1812 and 1815[21] brought Alexander Hamilton's ideas of protectionism to the fore. During this period various embargoes saw imports plunge, which in turn provided support for infant industries in the US. The US victory then allowed US expansion into the West, which provided an impetus for further US economic growth.

Following the end of the war, the Hamiltonian stance was adopted and import taxes were increased sharply to protect US industry. The culmination was the Tariff Act of 1828 known disparagingly as the "Tariff of Abominations" which saw a new high in tariffs. The uproar this caused resulted in tariffs being reduced in subsequent years, but tariffs were to become the major political issue as the US developed a two-party system: the Whigs (the forerunner to the Republicans) favoured high tariffs and the Democrats favoured lower tariffs. The Civil War marked a more protracted period of protectionism. The resolution of the war required greater tax revenues, but Abraham Lincoln hailing from the Republican Party saw the US adopting a much more protectionist stance. Import tariffs rose thereafter (Figure 5).

21 There were multiple causes for the war. Britain still had a foothold in the North-Western part of the US and was preventing the US colonists expanding westwards. It was also partly over violations of agreements made between the US and the warring European nations during the Napoleonic wars.

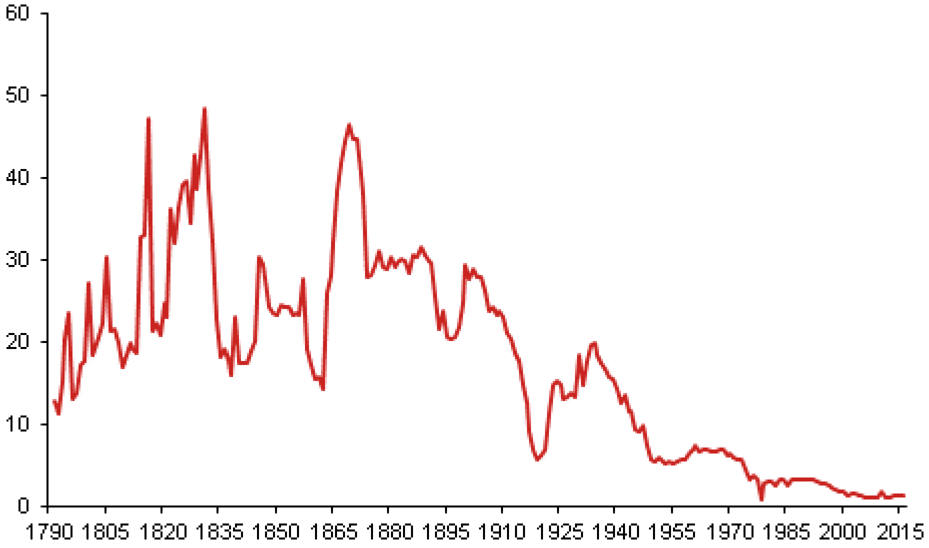
US transition to dominant power

In the late 1800s, the US emerged as the largest economy in the world[22] and the First World War saw that dominance increase. US exports exceeded British exports in 1915, and the US established a central bank, the Federal Reserve, in 1913. More importantly, hobbled by war debts all European countries suspended gold convertibility. The US dollar, though, remained convertible into the 1920s. The dollar overtook sterling to become the leading international reserve currency in the mid-1920s[23].

The return of the Republicans in 1922 saw higher import taxes, partly to protect the farming sector which had faced a downturn. Most European countries returned to a gold standard between 1924 and 1927. However, by 1929 the Great Depression struck. Countries responded in different ways to the crisis. Britain was early to leave the gold standard (1931), France held on, while the US responded with higher tariffs (Smoot-Hawley Tariff Act) and a devaluation. This began a series of retaliatory measures, which saw global trade fall further[24]. The negative fall-out from the Smoot Hawley Act saw a switch in opinion in the US against protectionism. In 1934, Congress passed the Reciprocal Trade Act which authorised the President to negotiate bilateral trade agreements. The view was that trade liberalisation was the path to prosperity.

Fig. 5: US import duties since 1790

Import duties as share of import value



Source: "New Estimates of the Average Tariff of the United States, 1790-1820" (Irwin, 2003), "Historical Statistics of the United States: Colonial Times to 1970" (US Department of Commerce, 1975), White House, US Census.

The Second World War saw the transition of the US to clear global hegemon, with a large economy and strong military. In fact, by the late 1940s, the US economy was four times the size of the UK's, six times the size of China's and, for the first time in history, larger than all the western European economies combined.

Why no weak dollar policy before the Second World War?

It is important to bear in mind that throughout this period currencies were tied to gold, silver or both. Therefore, nominal exchange rates between countries rarely changed outside of wars, which would force devaluations to stabilise gold outflows. From a policy perspective, this meant that import taxes were the main policy tools to address trade.

Outside of wars, currencies were rarely revalued or devalued against gold or silver (Figure 6). Instead, exchange rate debates at the time revolved around which metal to

22 There is much debate about whether protectionism helped or hindered the US during this time. Certainly, other factors such as: population growth both organic and immigration, the completion of the transcontinental railroad and the development of the Western parts of the US all contributed to US outperformance of Britain and France. Meanwhile, China's decline was accelerated by the British exporting of the illegal drug opium to China, which culminated in two opium wars. Through these wars, Britain gained control of Hong Kong, and opened mainland China to foreign trade.

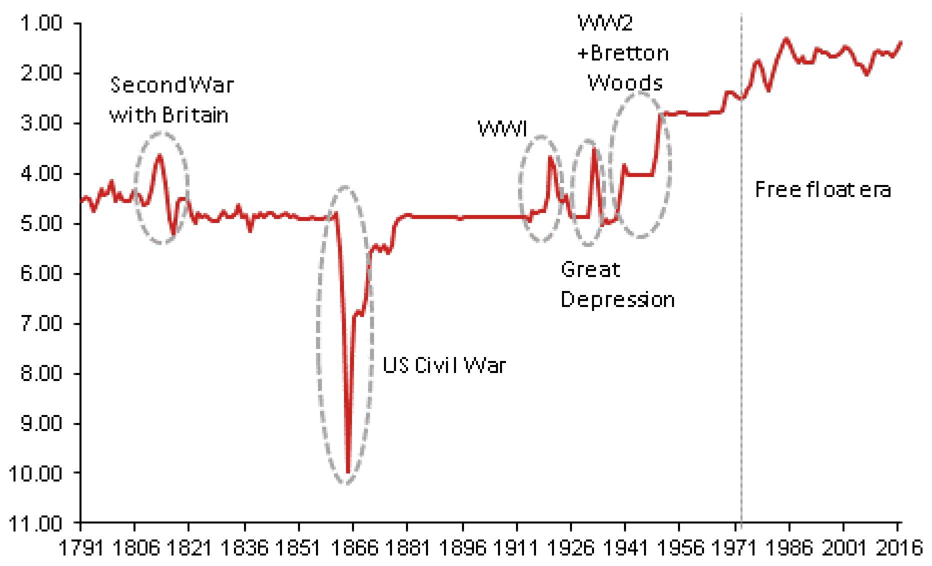
23 "The Euro May Over the Next 15 Years Surpass the Dollar as Leading International Currency" (Chinn and Frankel, 2008), "When did the dollar overtake sterling as the leading international currency? Evidence from the bond markets" (Chitu, Eichengreen and Mehl, 2012)

24 "The Gold Standard, Deflation, and Financial Crisis in the Great Depression: An International Comparison" (Bernanke and James, 1991)

link currencies to. In the middle of the 1800s, the western world was split between gold-standard countries such as Britain, silver-standard countries like the German states and bimetallic regimes (both silver and gold) such as France and US.

The debate was eventually settled by the discovery of greater gold deposits both in the US (through its westward expansion in 1848) and in British-controlled Australia (1851)[25]. In France, one of the major bimetallic countries, this led to a major increase in gold coinage at the expense of silver coins. In 1867, the International Monetary Conference was convened where all but the Netherlands voted in favour of gold becoming a global monetary standard. It is notable that the IMC was dominated by the European powers of the day rather than the US.

Fig. 6: The dollar since 1790



Source: Bank of England

German states used the silver standard, but soon after the creation of the German Empire (1871), Germany switched to the gold standard. By late 1873, France switched to gold, which marked the beginning of the classical gold standard era, when most of the western world adopted the gold standard. However, by the time of Bretton Woods in 1944, as currencies were initially fixed against the dollar and then floated in the early 1970s, FX had become a possible policy tool to boost trade.

Conclusion

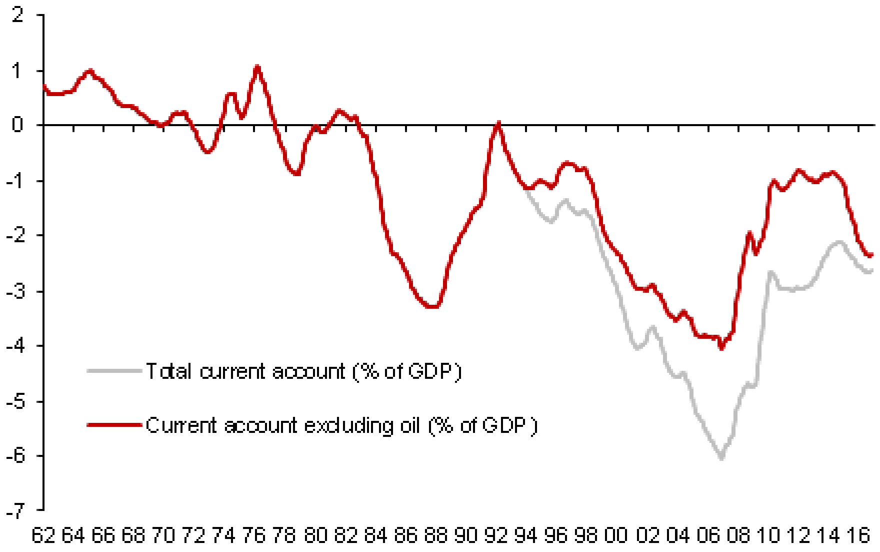
The world has changed. The financial crisis of 2008, the rise of China and the stagnation of economies has forced a re-evaluation of appropriate policy responses. Donald Trump's victory in the US Presidential election has introduced the possibility of a fundamental structural change in US trade policy – the first in decades. The consistency of Mr Trump's protectionist ideas over the years suggests that this is the most likely policy to be implemented. While it does mark a departure from Republican Party orthodoxy, a longer historical perspective shows that protectionism was traditionally a Republican stance all the way back to the party's founder, Abraham Lincoln.

As for the specifics, President Trump has various options. One is to re-negotiate existing trade agreements and switch to bilateral negotiations. A more dramatic path would to be impose import tariffs directly or indirectly (border tax) on other countries. Then there is the possibility of introducing a weak dollar policy. With the dollar at its highest level in real terms in 15 years and a recent sharp worsening in the non-oil US trade balance, there could even be a valuation-based argument for instituting such a policy (Figures 1 and 7). The implementation of such a policy would probably not match the Plaza Accord. It could take the form of a tweet, actual FX intervention or even the creation of a sovereign wealth fund. Needless to say, Donald Trump's position on trade policy should not be ignored.

25 "The emergence of the Classical Gold Standard" (Morys, 2012)

Fig. 7: US current account excluding oil has worsened over the past year

% of GDP



Source: Bloomberg

Appendix A-1

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