Caution on Dollar-Meddling
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If there's one theme tying together many of the policies President-Elect Trump and Congress will try to enact, it's making the US a better place to invest. This includes peeling back Obamacare, drastically cutting the top tax rate on corporate profits, moving from the depreciation of business investment to immediate and full expensing, and allowing more investment in energy infrastructure.

In addition, policymakers are seriously considering making the corporate tax code "border-adjustable." Right now, US companies are taxed on their total income, no matter where they earn their profits. (They get a reprieve on their foreign profits, but only as long as they leave that money outside the US.) A border-adjustable tax system would only tax income companies earn on sales in the US; income earned from exports would not be taxed.

Meanwhile, companies operating in the US would not be able to deduct the cost of imported inputs. In effect, companies located outside the US would be taxed on their US sales (our imports). Border adjustment is a feature the US would borrow from European-style VAT taxes, but without other unpopular parts of the VAT, like the inability of companies to deduct labor costs.

In theory, all this is supposed to encourage exports and discourage imports, in turn leading to a much smaller trade deficit. It also gives Trump a way to say he's fulfilled his campaign promises on trade issues without having to enact any special tariffs. Instead, the "tariff" would be buried inside the corporate income tax code.

So, just for the sake of discussion, let's say Trump and Congress enact all these policies and, in addition, thanks to more energy infrastructure, the US becomes a net petroleum exporter to the rest the world. Many voters and politicians would expect these changes to mean the US trade deficit would be on its way to extinction.

But this may not be so. In spite of these changes, the trade deficit could actually expand. Why? These policies will certainly make the US a better place to invest. Capital inflow will increase and this could, and should, boost the value of the US dollar versus other currencies, giving Americans more purchasing power to buy more foreign products. Meanwhile, the foreign capital sent to the US would mean foreigners would have less money to buy our products. The result could be that some foreign products become even more competitive.

This is not to say that these policy measures are worthless or self-defeating; they're certainly not. Cutting the tax rate on capital and making the US a better place to invest is a good policy regardless of the impact on the trade deficit.

But here's the problem. Policymakers will have a choice. One would be to accept better economic and wage growth and a lower unemployment rate and simply "declare victory," even if the trade deficit is at wider than current levels. That's the better choice.

But, throughout history, politicians have viewed a strong dollar and trade deficits as problems to solve. This is exactly what happened in 1985 with the Plaza Accord, when major currency countries agreed to generate a dollar decline after a large increase in the dollar's value in the early 1980s, after Ronald Reagan cut tax rates and reduced regulation.

The Plaza Accord lowered the value the dollar, led to more market volatility and eventually caused the Fed to ratchet up interest rates higher than it otherwise would have. It could turn into a recipe for a recession, which would be a shame given all the other positive changes that may be made.

Let's be clear, though. None of this is on the horizon, yet. At the earliest, it's a potential 2019-20 issue, not a 2017-18 issue, and may never happen at all. With the banking system still chock full of excess reserves, more economic growth may not lead to a prolonged dollar surge like in the early 1980s or late 1990s. And this time, hopefully, politicians will accept good economic news as a reason to let the market work.
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