The Exchange

US protectionism and deglobalisation spell inflation

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Over the past few weeks, market chatter has been preoccupied with speculation over the dire consequences of a strong dollar in a world of rising US isolationism and protectionism.

President Donald Trump's promise of a multi-hundred billion dollar fiscal stimulus in infrastructure and, in response, the prospect of three US Fed rate hikes through 2017 will support a strengthening dollar. But while this should help exporters to the country do well, the mounting protectionist stance — including plans for border taxes — will block cheaper imports. Worse, a rising currency would hurt countries with dollar-denominated debt by raising their costs, precisely when their export revenues fall as they face steeper US trade barriers.

While these economic links warrant concern, there is danger from another factor: backtracking on globalisation is likely to spur greater inflation and have an impact on investments and exchange rates. In particular, a shift toward more protectionist policies could not only weigh on global financial flows (according to the Institute of International Finance, against this economic backdrop, capital flows to emerging markets are projected to turn negative for the first time since 1988), but also increase the risk of debt defaults or, at the very least, restructurings.

In recent years, deflationary price effects have dominated the global economy, fuelled by low aggregate demand, debt overhangs and ageing demographics. This led to worry just six months ago that more than $13tn of sovereign debt, primarily in the eurozone and Japan, was in negative interest rate territory. However, the tightening US labour market underscored by low unemployment, moderately increasing commodity prices and the unwinding of globalisation toward greater isolationism are now shifting concern towards inflation.

Mounting protectionism and deglobalisation isolate economies — separating the global economy into its constituent parts. In such a world there will be no ability to send and distribute excess demand and excess supply from one economy to another via the global system, thus inflation will no longer be globally distributed but localised. Some countries — such as the US and Germany — will trend toward higher inflation, while others face deflation — notably commodity exporting countries in the emerging world, and specifically across Latin America, such as Argentina, Brazil and Venezuela, where weak economic conditions persist.

Central bankers in leading industrialised economies, including the US, had indicated that they wanted to see a pick-up in inflation and would accept the accompanying price increases, as they hoped to jump start a recovery and a return to solid economic growth in the aftermath of the financial crisis. Moreover, monetary policymakers have made desperate appeals for greater fiscal intervention (in the form of large infrastructure rollouts such as those proposed by Mr Trump) to spur economic growth.

These fiscal effects would, no doubt, be inflationary and, as a bonus, the price increases could help inflate US debt, thereby devaluing and reducing the debt obligation in real terms. Total US debt — including private, student, automobile and so on — stands at more than 330 per cent of gross domestic product.

However, now there are early signs of inflation,there appears to be a shift in some Fed voices, who instead seem keen to cut inflation off at the pass with a pre-emptive 75 basis points worth of rate hikes expected in 2017. Put another way, the Federal Reserve is unwilling to accommodate a nominal GDP of 3-4 per cent, if it comes with increasing inflation over the mandated 2 per cent.

Historically, it takes roughly 450 basis points to slow an overheating economy and within a year of that size of change a recession begins. Given that the interest rate bottom in the US was minus 3 per cent, after 75 basis points of hikes the fed funds rate will be around 1.5 per cent, with the total change reaching 4.5 per cent, thereby increasing the risk of placing US growth on a perilous slowing path and toward recession by the end of 2018.

Worse still, a path of interest rate rises implies that the economy will have neither enough inflation nor enough growth to dent the debt burden significantly. This increases the likelihood that borrowers will seek debt redress in the form of restructuring and possibly even default.

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