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The Economic Consequences of Mr Trump for South Asia

America matters to the world. To say that American growth and stability are international public goods, in the sense that they affect everyone around the world, is clichéd, but true nevertheless. Not just America's external policies, but even its domestic economic policies have a spill-over impact on countries beyond its borders. Virtually every country therefore has a stake in America's economic philosophy and policy; the stakes are even higher for emerging market economies such as those in South Asia whose prospects for growth and welfare are premised on the existence of a benign global economic order. Is it possible that this thought might be on the United States President-elect Mr Donald Trump's mind?

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The Prospect of the Trump Presidency– Two Consequences

The prospect of the Trump Presidency raises concerns for South Asia on two broad fronts.

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First, Trump campaigned on a platform of rewriting the rules of US engagement with the world which, coming on top of the vote for Brexit and the rise of right-wing nationalism in Europe, threatens the forces of globalization that have defined the liberal international economic order for much of the last 50 years. These inward-looking developments come at a time when globalization is already stalling, if not actually regressing. For a quarter century before the Lehman financial crisis in 2008, global trade expanded at a scorching pace – not just outpacing global output growth, but outpacing it by several multiples. Today, global trade is hardly able to keep pace with global output growth, raising concerns that it is not just cyclical factors but deep-rooted structural factors that are at play.

What might the de-globalization agenda of Trump, coming at such a juncture, mean for South Asia – especially for its aspirations for rapid growth and broad-based poverty reduction?

As a region, South Asia has been late in coming into globalization. Even as other regions of the emerging world, particularly in East Asia and Latin America, produced growth miracles of varying quality and sustainability, ostensibly as a result of opening up to global market forces starting in the 1970s, South Asian economies remained locked into slow growth and low incomes. This was widely attributed to their inward economic orientation, characterized by wide-ranging controls on movement of goods and capital. It was only in the 1990s, and increasingly in the new millennium, that they started liberalizing ever so cautiously – crossing the river by feeling the stones as it were.

Globalization has never been - and never will be - a totally benign force. It brings immense benefits by way of opportunities for leveraging on global synergies for domestic growth and welfare; but it also imposes ruthless costs by exposing fragile developing economies to the brutal volatility of global economy and finance, as indeed evidenced by the global financial crisis of 2008. The challenge lies in minimizing the costs and maximizing the benefits.

The ability to manage that challenge varies across regions. East Asia and Latin America are arguably better equipped to withstand global shocks because of their middle income status than South Asia which is decidedly low income. For sure, South Asian economies have a huge and compelling agenda on the domestic front – they have to implement

structural reforms, increase investments in education and health and improve governance. But in order to realize their aspirations for growth and welfare, they also need a conducive global environment characterized by steady growth, open trade, a stable financial sector, and most of all, a predictable policy environment.

With its large economy, open market orientation and deep and liquid financial markets, America has for long provided leadership to the liberal international economic order. That leadership has not always been flawless nor unselfish, but on balance it served the world well. Might the Trump policy agenda, including the prospect of America relinquishing its leadership, upend the global order and complicate economic management in emerging markets in general and South Asia in particular?

The second broad concern for the outside world is that Trump comes into office with the promise of a huge fiscal stimulus to the US economy – big cuts in taxes and large increases in spending on infrastructure and defence – aimed at raising growth and creating jobs at home. Even though fiscal policy is quintessentially domestic, given the size of the US economy and the centrality of the American dollar to the global financial system, the Trump fiscal stance will have strong and potentially destabilizing impact on the rest of the world including emerging markets.

Coping with destabilizing forces is always costly and complex, even more so if destabilisation stems from external sources over which a country has no control. The challenge is particularly compelling for South Asian economies if only because they have the least ability to cope with instability.

Based on these two broad concerns, this paper examines the challenges that the Trump Presidency will throw up for South Asian economies.

Fiscal Stimulus

The spill-over from the Trump fiscal stimulus will manifest through a variety of channels. First, looser fiscal policy in the US will mean tighter global financial conditions, higher bond yields and increased interest rates in South Asia at a time when they are looking to raise investment activity through lower interest rates and softer bond yields. Second, stronger growth in the US will likely put upward pressure on commodity prices, particularly of oil, which again will hit South Asia disproportionately because of its larger

dependence on commodity imports. Third, the slashing of corporate taxes, an important component of the Trump fiscal plan, will make domestic investment a more attractive option for US corporates, thereby inhibiting foreign direct investment into emerging markets. This too will hit South Asia more than other emerging regions as the former's plans for faster growth and job creation are based on larger flows of FDI. Besides, lower foreign direct investment which is more stable, will increase South Asian dependence on portfolio flows in managing their balance of payments.

Financial Stability

By far the most important channel through which US fiscal expansion will impact South Asia will be through the exchange rate channel. In the one month since Trump's election victory, the dollar recorded its sharpest rise in decades against a basket of peers, and it is likely to remain firm if Trump embarks on his fiscal plan soon after assuming office. Many corporates in South Asia which, tempted by the near-zero interest rates in the US during the reign of 'Quantitative Easing (QE)', borrowed in dollars have suddenly found their repayment burden shoot up as a result of the depreciation of their domestic currencies. This headwind comes at a time when corporates across South Asia are already under pressure because of the burden of non-performing assets.

In theory, we should expect faster growth in the US and a stronger dollar to support emerging economies through higher demand for their exports. Disappointingly, that positive effect will likely be neutralized by Trump's protectionist policies (more on that later).

What would worry South Asia more than the level of the dollar exchange rate is the volatility in that exchange rate. A volatile exchange rate of their currencies against the dollar will make South Asian economies even more vulnerable to the vagaries of fickle capital flows – money which comes in when yield differences and exchange rates are favourable and exits just as swiftly when those conditions turn the other way. India, for example, has experienced portfolio outflows in the one month since the Trump victory at a rate not seen since the 'taper tantrums' of 2013 when capital fled the Indian economy plunging the exchange rate and jeopardizing financial stability.

Why should we expect the dollar exchange rate to be volatile going forward? For a host of reasons. First, because the dollar, which seems already overvalued, could likely spin into a self-reinforcing upward spiral under the impending Trump fiscal stimulus

The second reason for concern about dollar volatility is the uncertainty about how the Fed might react to the Administration's fiscal stance and Trump's bewildering communication practices. Note that the Trump stimulus, being touted as Reaganomics rerun, comes at a time when the US economy is at near-full employment, holding out the threat of accelerating inflation and higher interest rates. Will this heightened concern about inflation prompt the Fed to hike rates faster and sooner than it had indicated in its forward guidance and, in the process, run the risk of forcing the economy into a recession? Or would the Fed, as some economists reckon, run the economy 'red hot' for a year or two, allowing demand to outstrip potential output, thereby energising the economy onto a higher growth trajectory?

The Fed's dilemma will likely be compounded by Trump's shifting position on this issue. At various times during the campaign, he was on "both sides of the issue", sometimes berating the Fed for running a soft interest rate policy, and at other times flipping seamlessly to describe himself as a "low interest rate guy". Although the Federal Reserve acts independently of the Administration, the latter's views, especially if they are time-inconsistent, have the potential to undermine Fed independence, and at any rate muffle the signal and threaten financial stability, not just in the US but around the world. In particular, abrupt and unanticipated policy adjustments by the Fed could make the dollar volatile, leading to bouts of capital flight from emerging economies, threatening their financial stability and external sector viability.

Over the last ten years, as South Asian economies have integrated more deeply into global finance, they paid a heavy price during episodes of global instability – during the Global Financial Crisis in 2008, during the QE regime that followed during 2009-12 as well as when the QE was tapered in 2013. Global financial stability and a stable dollar are more critical than ever for South Asian economies to realize their aspirations for rapid growth and broad-based equity. That the Trump economic policies might derail those aspirations is a growing concern.

Protectionist Policies

As a candidate, Trump was most voluble on his protectionist policies – withdraw from TPP, renegotiate NAFTA, label China a currency manipulator and slap hefty tariffs on imports – all aimed at ‘reshoring’ production and creating jobs. Whether these mercantilist policies will deliver the intended outcomes is highly questionable; but they are sure to destabilize world trade, and even more so if other countries retaliate.

The stereotype view is that a turmoil in global trade is unlikely to hurt South Asia if only because their export sectors are small relative to GDP. But precisely because their exports are small do South Asian countries have a big stake in ensuring that global trade remains open and keeps expanding. South Asia, as indicated earlier, was late coming into globalization and missed out on the export-led growth experienced first by the East Asian Tigers in the 1980s and China in the 1990s. South Asians’ ability to replicate the earlier growth models is already being challenged by the declining importance of cheap labour as a determinant of comparative advantage. Those headwinds will be further reinforced by Trump’s protectionist policies, jeopardizing their plans for growth and welfare.

Trump’s protectionist policies encompass also controlling immigration. It is not clear if his immigration reforms will remain restricted to dealing with illegal immigrants or if they will also extend to immigration of skilled professionals. If the latter, South Asia, as a large supply pool of professional immigrants to the US, will be hurt. There is ample evidence to show that immigration of professionals has benefitted both home and host countries – host countries by way of higher output and high-end jobs, and home countries by way of remittances and diffusion of talent. South Asia will have another worry if Trump’s immigration reforms turn out to be more militant than now seems likely.

Global Economic Governance

Globalization has made the world flat, but only in some respects. In many important ways, the playing field remains uneven, with advanced economies controlling the rules of global economic governance. The governance of the IMF and the World Bank is controlled by the advanced economies, with conditionalities imposed on borrowing countries as per the ‘Washington Consensus’, unmindful of the hardship and even economic damage it might cause to the latter. The global rules for financial sector

regulation are set by the Financial Stability Board where emerging economies, despite a seat at the table, are unable to influence policy decisions. The G20 is more inclusive but has failed to live up to the high expectations it raised after the extraordinary unity of purpose and resolve it showed in resolving the Global Financial Crisis. With the immediacy of the crisis behind it, the fault-lines among the G20 countries have started showing up once again, and it has shown itself to be unable or unwilling to grapple with the many complex problems that the global economy faces.

It is into this quagmire of asymmetric relationships and conflicting interests that Mr Trump steps in with his muscular policies for domestic stimulus and disengagement from global economic governance. Surely American leadership of global institutions has often been flawed and has not always been driven by collective self-interest. But it cannot be anyone's case that global economic governance will improve if America withdraws. On the contrary, American withdrawal could make the situation even worse. America matters to the world because of the size of its economy, the pivotal position of the dollar as the world's sole reserve currency and the depth of global integration whereby what happens anywhere in the world affects countries everywhere.

American Leadership

A world divided by nation-states, but sharing an increasingly common economic space, needs enlightened leadership that puts collective self-interest above narrow domestic interests.

This matters to every country but more so to South Asia which houses more poor people than any other region in the world. South Asia's growth and prosperity are critically dependent on a benign global economic order for which America's continued engagement with the world and constructive leadership of the international economic order are essential.

Is it possible that this thought might be on Mr Trump's mind?

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