

David Skilling & Michael O'Sullivan

Nikkei Asian Review, 23 December 2016

Small economies must brace for the Trump era, and a changing global economic & political order

Voltaire's Candide saw that 'all is for the best in the best of all possible worlds'. Financial markets appear to be doing the same with President elect Donald Trump's economic programme, assuming that he can produce a set of policies that will further strengthen the US economy.

Markets have applauded the likelihood of expansionary fiscal policy taking over from loose monetary policy in the U.S. Although there had been concern in financial markets prior to the presidential election about the possibility of a major sell-down in the event Donald Trump won, since November 8 U.S. equity markets have rallied to record highs.

Equity markets in many Asian countries are also up, including those of Japan, Australia and Singapore. The U.S. dollar is at 14-year highs on expectations of stronger domestic growth and a more aggressive pace of Federal Reserve interest rate increases.

Many Asian currencies have depreciated, perhaps most notably the yuan. The December 14 Fed rate rise was likely anyway, but the post-election bond market reaction has raised the odds of more aggressive moves in 2017.

It is early days, but as with the Brexit vote in June, the immediate evidence of economic damage since the U.S. election seems scarce relative to the concern beforehand. Are markets inappropriately pricing in a boom, in a similar way they are often said to have predicted nine of the last five recessions?

To provide another perspective on the likely impact of the Trump presidency on the global economy, it is useful to take a small country view. Small countries are deeply exposed to economic and political decisions by large countries and provide useful guidance on emerging dynamics. Many small countries, perhaps particularly in Asia, are anxious about possible structural risks to globalization under the new administration, looking beyond the market's apparently optimistic initial assessment.

Consider the small country perspective on three key risks.

The first is that if the Trump administration delivers an infrastructure spending program in 2017, it may well overcook the U.S. economy at a time when the labor market is already tightening. Reactions to such a scenario, likely involving a stronger dollar, higher bond yields and more Fed rate increases, could prove the makings of a 2018 recession.

Foreign exchange markets will be quick to express this risk, and the year ahead may be marked by higher volatility for the currencies of small, open economies. Small economies tend to be price takers of monetary policy conditions in larger countries.

This has been the case during the quantitative easing of the past few years, with small economies such as Denmark and Switzerland responding by setting negative interest rates. From Hong Kong to New Zealand,

monetary policy settings in small Asian economies have been looser than domestic fundamentals would suggest.

Because of this, the normalization seen so far of U.S. rates has been a net positive for many small economies. But a rapid reversal, with the risk of volatility and overshooting, will cause complications. Significant rate rises and dollar strength would create challenges for borrowers with U.S. dollar debts, particularly in emerging markets.

The planned U.S. withdrawal from the Trans-Pacific Partnership, the potential for new tariffs on American imports, friction with China on currency issues as well as the potential for significant changes to pacts such as the North American Free Trade Agreement are likely to have a major dampening effect on trade and investment. This would indeed be Trump's promised "Brexit plus plus plus".

There is concern across small open economies about a significant reduction in Washington's commitment to globalization. Small Asian economies, from Singapore to New Zealand, would be particularly exposed to this dynamic.

Small open economies have prospered on the back of intense globalization over the past few decades, are leveraged to it and stand to lose a great deal if it weakens. These countries will act as barometers of the economic climate of the Trump era. Already the trend rate of growth in small advanced economies is at the bottom end of the range of the past few decades, under the weight of stagnant global trade. Hong Kong and Singapore, for example, are generating gross domestic product growth rates of less than 2%. A more closed trading system would bring additional economic risks.

Small economies in Asia and Europe are preparing for these risks by getting their domestic houses in order. Fiscal consolidation from the aftermath of the global financial crisis is well advanced and will provide fiscal space to respond to future shocks. Small economies also understand the importance of market diversification. But even with these efforts, small economies will be highly exposed to a changing international economic regime.

Because of this, there is an imperative for small countries to work to shape the international economic system. Indeed, the economic risks emerging from a Trump presidency may be the catalyst for small countries to convene together to discuss common problems and common solutions.

Another risk is of the unwinding of the international political order, with a greater emphasis emerging on big power relations. The nature of the phone conversations between the President elect and political leaders in Pakistan and Taiwan suggests a very different U.S. approach to international relations can be expected, with a heightened risk of turbulence.

Small Asian countries would once again be particularly exposed to such changes. To the extent that the new administration has a preference for doing deals with other larger countries, from Russia to China, small countries may be "stuck in the middle." This would raise the expectation of much more active hedging behavior by small countries, from Singapore to Scandinavia, to try to balance big power relations as well as economic and political interests.

Overall, the concern in many small countries is that the Trump victory signals a sea change in the liberal economic and political order. Small countries are the place to look to understand whether this will be the case, the nature of the implications and how to respond.

About the authors

Dr David Skilling is the founding Director of Landfall Strategy Group, which was established in 2011. David advises governments, companies, and financial institutions in several small countries, and writes regularly on global macro, globalisation and geopolitics from a small country perspective. David has recently served as Senior Advisor to the Secretary of Foreign Affairs & Trade in New Zealand, and as a Fellow at Singapore's Civil Service College. Previously, David was an Associate Principal with McKinsey & Company in Singapore, as well as being a Senior Fellow with the McKinsey Global Institute. Before joining McKinsey, David was the founding Chief Executive of the New Zealand Institute, a privately-funded, non-partisan think-tank. Until 2003, David was a Principal Advisor at the New Zealand Treasury. David has a Ph.D. in Public Policy, and a Master in Public Policy degree, from Harvard University, as well as a Master of Commerce degree in Economics from the University of Auckland.

Dr Michael O'Sullivan is a Managing Director of Credit Suisse in the Wealth Management Division, based in Zurich. He is Chief Investment Officer for the International Wealth Management Division. He joined Credit Suisse in July 2007 from State Street Global Markets. Prior to joining Credit Suisse Michael spent over ten years as a global strategist at a number of sell-side institutions and has also taught finance at Princeton and Oxford Universities. He was educated at University College Cork in Ireland and Balliol College in Oxford, where he obtained M.Phil and D.Phil degrees as a Rhodes Scholar. He is an independent member of Ireland's National Economic Social Council. He is the author of two books, including 'Ireland and the Global Question'.

contact@landfallstrategy.com

www.landfallstrategy.com

twitter: @dskilling

Copyright © 2016 Landfall Strategy Group Pte. Ltd.
(UEN 201109428E), Singapore. All Rights Reserved.