Deep Dive – Trump's Policy Inconsistencies and Risks for the Dollar

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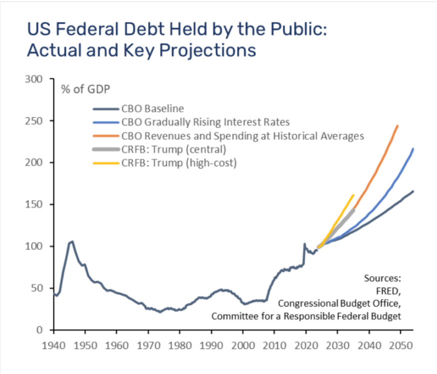
[https://www.systemacro.com/deep-dive-trumps-policy-inconsistencies-and-risks-for-the-dollar/print/] We attempt to analyse the different transmission channels through which Trump's expected macroeconomic policies would shape the Dollar outlook. In Section I, we discuss fiscal policy, debt sustainability and the likely rise of the term premium. This is followed by an analysis of how monetary policy will likely change under Trump. In Section III, we look at some of the most striking policy inconsistencies, which amplify uncertainty about the economic policy outlook. Finally, we look at the likely implementation time-line, as the net Dollar impact may also be a function of the speed with which the incoming administration puts the specific policies into place.

Section I: Fiscal Policy and Debt Sustainability

Compared to the first Trump Presidency, the fiscal starting point is very different. Despite still robust growth, the deficit has reached levels not seen outside deep recessions or wars. Warnings about an unsustainable debt trajectory multiply why risk premia remain surprisingly low. Perceptions of debt sustainability remain one of the most important issues as a confidence crisis could undermine any Dollar positive impact from Trump's likely economic program.

Problem 1: Debt Levels and Interest Payments

Debt sustainability metrics depend on a few key assumptions regarding growth, inflation, interest rates and projected government policies on revenues and expenditure. It is therefore not a surprise that the different debt simulations project vastly different outcomes. Still, US debt is on a non-stabilising trajectory according to detailed analyses by a number of institutions, namely the Congressional Budget Office (CBO), Committee for a Responsible Federal Budget (CRFB), or the IMF. One problem all these institutions have is that their baseline projections incorporate current legislation, which tends to be too optimistic. For that reason, it is important to look at some alternative simulations (see chart).



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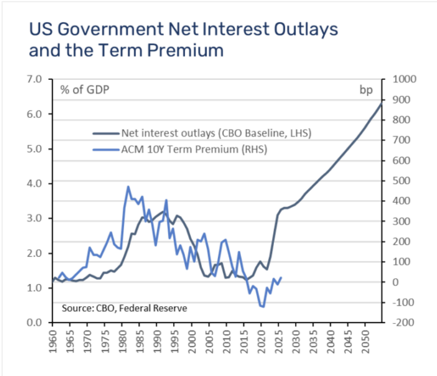


[https://www.systemacro.com/wp-content/uploads/2024/11/US-Government-Net-Interest-Outlays-and-the-Term-Premium-v2.png]

For example, most fiscal policies that involve higher deficits also include provisions to reduce these deficits sometime in the future. However, that rarely happens in reality because in following years new legislation often extends the temporary provisions. To overcome this problem some simulations assume revenues and spending at historical averages, which is considerably worse than the baseline of current legislation.

The second important reason why some baseline scenarios are too benign are the assumptions regarding interest rate payments. The CBO has constructed a scenario based on the assumption of gradually rising interest rates relative to their baseline (additional 5bp per year). This adds some 1.5 percentage points to the assumed interest rate at the end of the projection horizon at around 2050. One could think of this as a term premium, directly related to the level of outstanding debt. Back in the 1990s the term premium on US 10yr rates stood in the 300-400bp area (see chart above), in other words, even the rising interest rate scenario is quite benign relative to what has already happened in fairly recent US history. To highlight the relevance of the mid-90s, the second charts plots interest expense against the two most widely observed term premium estimates.

Some simulations explicitly attempt to project the fiscal impact of Trump's policy proposals, for example those from the "Committee for a Responsible Federal Budget", which also tend to look considerably worse than baseline projections.

The key point is that US fiscal policy is an unsustainable trajectory, probably worse than baseline simulations assume. Without any significant policy change in the US to reduce the budget deficit materially, it is only a question of time before the US drifts into a fiscal crisis scenario.

CBO: Long-term Budget Outlook: 2024-2054, published March 2024 [https://www.cbo.gov/publication/59711]

CBO: The Long-Term Budget Outlook Under Alternative Scenarios for the Economy and the Budget, published May 2024 [https://www.cbo.gov/publication/60169]

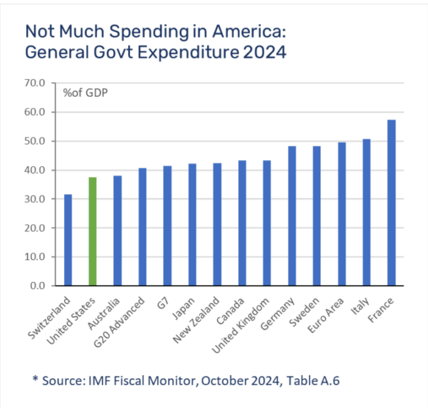
Committee for a Responsible Federal Budget: The Fiscal Impact of the Harris and Trump Campaign Plans, published October 2024 [https://www.crfb.org/papers/fiscal-impact-harris-and-trump-campaign-plans]

IMF Fiscal Monitor: Putting a Lid on Public Debt, published October 2024 [https://www.imf.org/en/Publications/FM/Issues/2024/10/23/fiscal-monitor-october-2024]

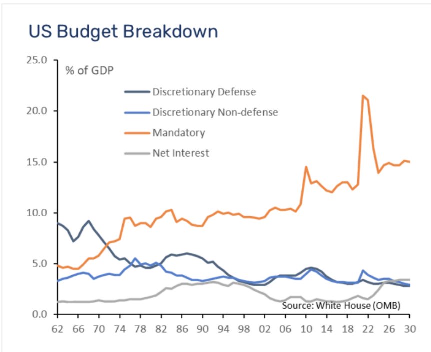
Problem 2: Limited Scope to Cut Government Expenditure

Trump and Elon Musk currently make a big deal out of efficiency gains and their plans to cut government spending to finance more tax cuts. But this will be very difficult when looking at the maths of current expenditure.

The first hint is that US spending is already quite low in international comparison, well below the average of advanced economies (see chart below). Consequently, additional expenditure cuts are at a higher risk of undermining the proper functioning of a government and or will meet significant political resistance, which considerably reduces their likelihood of success.



[https://www.systemacro.com/wp-content/uploads/2024/11/Not-Much-Spending-in-America.png]



[https://www.systemacro.com/wp-content/uploads/2024/11/US-Budget-Breakdown.png]

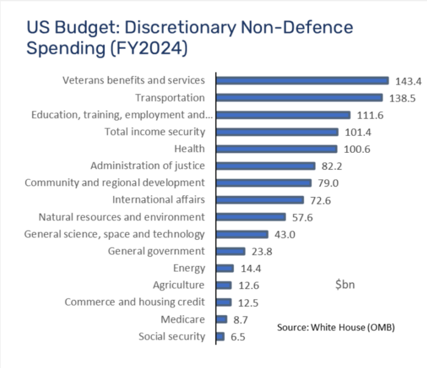
If we focus on the Federal Government alone, total outlays in fiscal year 2024 can be broken down into 14.7% of GDP for Mandatory programs, including Social Security, Medicare and Medicaid, as well as 3.1% for Discretionary Defence spending and 3.1% for net interest payments. The remaining part of this breakdown is Discretionary Non-Defence Spending, accounting for 3.5% of GDP.

One of Trump's campaign promises (#14) is to "**Fight for and protect social security and medicare with no cuts, including no changes to the retirement age. [https://www.donaldjtrump.com/platform]** " This essentially means that the large mandatory programs, hugely popular among working class MAGA supporters will remain in place. The focus is therefore on discretionary spending. Trump's campaign promise #12 is to "**Strengthen and modernize our military, making it, without question, the strongest and most powerful in the world [https://www.donaldjtrump.com/platform]** ." This suggests that Discretionary Defence spending is unlikely to shrink either.

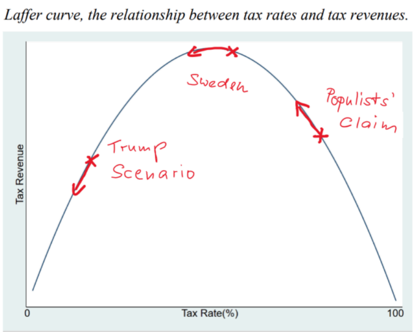
Cuts to expenditure therefore have to come from Discretionary Non-Defence spending. However, this item only accounts for 3.1% of GDP compared to US budget deficit in Fiscal year 2024 that was significantly larger at about 6.5% of GDP. Even when cutting all Discretionary Non-Defence spending, the resulting deficit would still only decline to historic long-run averages.

In 2024, discretionary fiscal spending on non-defence amounted to almost exactly $1tn in current Dollars (see table 8.7 on the **OMB page of the White House [https://www.whitehouse.gov/omb/budget/historical-tables/]**). Of this, the largest item is on Veterans' benefits ($143bn), including dedicated health care. Even Elon Musk has so far refrained from mentioning this line item as a potential source of efficiency savings. Another $208bn of extended tax cuts will simply widen the deficit further – without much offsetting reductions in expenditure. This has been a recurring pattern in US fiscal policy for decades as the steadily rising debt levels also indicate.

[https://www.systemacro.com/wp-content/uploads/2024/11/US-Budget-Discretionary-Non-Defence-Spending-FY2024.png]



[https://www.systemacro.com/wp-content/uploads/2024/11/US-Budget-Discretionary-Non-Defence-Spending-FY2024.png]



[https://www.systemacro.com/wp-content/uploads/2024/11/Laffer-Curve.png]

Problem 3: Tax cuts no longer pay for themselves

The incoming Trump administration will almost certainly use the claim that tax cuts pay for themselves by stimulating growth and subsequent tax take. This is known as the Laffer curve (see sketch above). The problem is that it only works under very specific circumstances, namely debilitatingly high initial tax rates, which create counterproductive incentives. People work less hard because additional income will go to a large extent to the government. Similarly, companies may decide to relocate abroad if corporate tax rates are too high. By lowering the rate from extreme levels, tax revenues may indeed rise. Sweden is an example, where **academic research [https://www.diva-portal.org/smash/get/diva2:1339089/FULLTEXT01.pdf]** suggests that overall tax revenues decline for marginal tax rates above 60%. Similarly, many economists believe that US tax revenues increased when Reagan lowered the top rate income tax rate from 70% to 50% in 1981. However, current income and corporate tax rates in the US are well below these levels. And the parabolic shape of the Laffer curve implies that the budget impact of lowering tax rates is particularly bad when tax rates are already very low. As a result, additional Trump tax cuts would worsen the US fiscal position disproportionally.

Problem 4: Non-Linearity in the Perception of Fiscal Risks

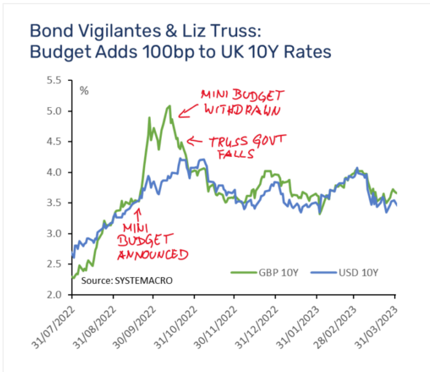
A recent survey by the CFA Institute (see link below) produced a striking inconsistency in the perception of fiscal risks:

> *"A supermajority of respondents (77 percent) believe U.S. government finances are not sustainable, while 59 percent of respondents believe investors remain confident in the United States' ability to freely borrow to fund government operations and interest obligations."*

Moreover, "a majority of respondents (61%) also think that the US will not be able to reduce its debt to GDP ratio [..] or otherwise contain deficit spending."

The 4000 investment professionals globally, surveyed by the institute are therefore perfectly aware of the worrisome debt situation in the US. They also don't think the situation will improve, but they think global bond markets will continue to absorb any US issuance. So far this is obviously corroborated by the low term premium (see Problem 1 above).

[https://www.systemacro.com/wp-content/uploads/2024/11/Bond-Vigilantes-Liz-Truss-Budget-Adds-100bp-to-UK-10Y-Rates.png]



In a sense this result suggests the US Treasury market displays features of a speculative bubble, because people no longer buy the asset for its intrinsic value. Just how quickly the fiscal risk premium can rise became clear when Liz Truss' mini budget woke up the "Bond Vigilantes" in the UK. Within hours, an idiosyncratic 100bp risk premium had been added to 10-year rates (see chart). Interestingly, there are parallels between the Trump and Truss approach to fiscal policy.

Finally, the nomination of a Scott Bessent as market-savvy Treasury Secretary, may help with the promotion of Trump's fiscal policy proposals. But this does not change the numerical problem additional tax cuts with inadequate offset in reduced expenditure will worsen the US fiscal and debt trajectory.

CFA Institute: Survey Highlights Investment Industry's Concerns over Soaring U.S. Government Debt, published October 2024 [https://www.cfainstitute.org/about/press-room/2024/survey-highlights-government-debt#:~:text=A%20supermajority%20of%20respondents,dichotomy%20revealed%20in%20the%20report.]

Section II. Central Bank Independence

In the previous Section, we highlighted the risks arsing from concerns about high levels of US government debt. Critical in any assessment of debt sustainability is the assumption of inflation. While high inflation rates may help debase the debt pile in real terms and improve debt to GDP ratios, forward looking investors typically want compensation for these risks. Expectations of tighter monetary policy will directly lead to higher yields. Moreover, if markets perceive risks that the central bank will fail in delivering on the inflation mandate, a rising term premium will lead to higher yields, too.

Issue 1: The President's Monetary Policy Preferences

While in power, Trump only ever criticised the Fed for not having eased policy more. During his recent election campaign, he criticised the Fed for not being hawkish enough, and hence supporting the Biden/Harris administration. This would tentatively suggest that Trump primarily sees more accommodative monetary policy as a tool to boost the popularity of a government. Obviously, his background as an – at times highly leveraged – property developer, likely also creates an instinctive bias to prefer lower interest rates. We expect that the pressure on Fed to cut rates will increase rapidly now that Trump has won the election.

Issue 2: Government Interference

During Trump's first term, his attempts to influence monetary policy have been frequent and one-sided. He put continued pressure on the central bank to **lower policy rates to weaken the Dollar [https://x.com/realDonaldTrump/status/1179041970590748672]** . During his recent campaign he again complained about high interest rates and how they hurt potential house buyers. **One idea floated by Scott Bessent [https://www.bloomberg.com/news/articles/2024-11-23/trump-s-treasury-pick-wants-shadow-fed-chair-maybe-weak-dollar]** , the likely new Treasury Secretary, is to create a "Shadow Fed Chairman" by front-loading the nomination of a successor to current Chairman Powell. The idea is that the future Chairman has the ability to guide markets into a different direction than the current FOMC.

The more fundamental point is that an institution like the Fed is never truly independent. It has been created by law, and its remit can be changed. Its key decisions makers are appointees by successive governments. If the government fails to credibly defend the independence of the Federal Reserve, and openly criticises monetary policy, confidence in long-term prices stability will likely erode, in particular if the pressure is biased toward lower interest rates.

[https://www.systemacro.com/wp-content/uploads/2024/11/Trump-Tweet-on-Powell-2019.png]

Issue 3: Nomination of a New Fed Chair

While the nomination of a new Chair – Powell's term expires in May 15, 2026 – is the most obvious opportunity for political interference. The views and preferences of the new Chairperson play a role as well. Once nominated, the new Chair control the Fed's agenda. During his first Presidency, Trump already interviewed candidates with un-orthodox views. Given how critical he remained of the more orthodox Powell chances have increased that unorthodox candidates will again be shortlisted. The nomination of such a candidate would likely represent a risk for long-term inflation expectations.

Section III. Policy Contradictions

In this section, we try to isolate some of the policy contradictions that frequently appear in Trump's economic policy discourse. These contradictions are likely the result of a populist tendency to promise everything to everyone. The risk is that continued contradictory promises create uncertainty and undermine market confidence, which brings us back to the primary issue of debt sustainability above.

partly because of the less-efficient allocation of resources. The outcome of a trade war is very similar to a negative productivity shock. Trump wants to use Tariffs to raise growth – it's not going to work.

The **Tax Foundation estimated [https://taxfoundation.org/research/all/federal/tariffs/]** that the Trump-Biden tariffs lowered US trend growth by about 0.2%, while also reducing employment and investment. Some of Trump's recent proposals on Tariffs (10% or 20% globally and 60% or more on China) are potentially 5x worse, when judged by potential tariff revenue. The macroeconomic impact of these proposals would therefore hurt growth even more.

Contradiction 2: Tariffs versus Lower Inflation

Tariffs directly lead to an increase of import prices. To the extent that these will be passed on to consumers, tariffs may therefore raise consumer prices too. And in fact, a **2021 NBER paper, reviewing the academic research [https://www.nber.org/system/files/working_papers/w29315/w29315.pdf]** on the impact of Trump's 2017-2021 tariffs concludes: "The main takeaways from this research is that US consumers of imported goods have borne the brunt of the tariffs through higher prices […]".

Contradiction 3: Weaker Dollar versus Strengthened Reserve Currency Status

In the past, Trump has often complained about foreign countries devaluing their currencies, and implicitly strengthen the Dollar, to gain an unfair advantage over US manufacturers. Similarly, he **attacked the Fed [https://www.telegraph.co.uk/business/2019/08/30/trump-blames-fed-problem-strength-us-dollar/]** for keeping rates too high and supporting the Dollar. At the same time, he wants to keep the **Dollar as World's reserve currency [https://www.donaldjtrump.com/platform]** . Foreign holders of Dollars in their FX reserves may not appreciate if the US President openly calls for a weaker currency.

Contradiction 4: Weaker Dollar versus Lower Inflation

By weakening the Dollar, import prices rise (in addition to the impact from possible tariffs), which would likely contribute to higher inflation. From a purchasing power point of view, relatively lower inflation is associated with a stronger nominal currency in the long-run.

Contradiction 5: Lower Interest Rates and Tax Cuts versus lower Inflation

Ceteris paribus, fiscal expansion and monetary stimulus is typically inflationary. And yet, **Point 3 of Trump's agenda [https://www.donaldjtrump.com/platform]** is to "end inflation."

Section IV. Sequencing the Dollar Impact of Policy Implementations.

Different policy proposals have different implementation time lines. Below we try to dissect the related impact on the Dollar.

General Policy Uncertainty – Front-loaded – Likely USD negative. The numerous inconsistencies in Trump's economic proposals (see Section III), the obviously inflationary impact of some policies, plus the autocratic bias already observed during his first presidency create uncertainty. While some pockets of the economy may clearly benefit form specific measure, the overall increase in uncertainty, may well become one of the biggest issues for investment in the US, including by foreigners.

Higher tariff rates – Front-loaded – Increasingly less USD positive. The President has **wide-ranging powers [https://crsreports.congress.gov/product/pdf/IF/IF11030]** to change tariff rates. This would suggest that tariffs will start to rise as soon as Trump assumes office. The first order impact of higher tariffs is likely USD positive as it can be seen as a negative productivity shock on foreign manufacturers of tradable goods. However, when taking negative income effects in the US into account and the likelihood of tariff retaliation, the initial Dollar positive impact may quickly disappear.

Talking down the Dollar – Front-loaded – USD negative. Partly to offset any initial Dollar positive impact from tariffs it seems likely that the Trump administration will very quickly start to complain about any USD strength.

Increased pressure on the Fed to ease policy – Front-loaded – USD negative. While the Fed Chair remains in place until 2026, the government will likely start immediately with putting more pressure on the Fed. By criticising monetary policy as unhelpful for Trump's supporters and via a front-loaded nomination process for the next Fed Chair, the administration can rapidly reduce the perceived independence of the US central bank.

Tax cuts – Delayed impact – USD ambiguous. There are two issues with the timing of fiscal policy easing. First, it needs to pass through Congress and some of the extreme proposals from the Trump administration may struggle in the House, where the Republican majority is slim. Moreover, once a fiscal package has been agreed, it may take a number of months before people actually see the different in their wallets. Much depends on tax deadlines and the time it takes to implement new legislation. If the expected tax cuts undermines confidence in the US Treasury market, the dominating impact would likely be Dollar negative. Such a shift in debt sustainability concerns can materialise almost instantaneously, and much faster than any cyclical positives from lower taxes.

Mass Deportations – Gradual/late Implementation – Somewhat USD negative. The deportation is naturally bottle-necked by the capacity of the enforcement system. Expanding the enforcement system takes time in itself. As a result, the inflationary impact of a shrinking workforce and lower trend growth will likely be very small initially and only gradually become stronger over the entire Trump presidency. The process may be even slower if legal challenges slow the process. Still to the extent that trend growth will decline, the overall impact will likely be somewhat Dollar negative – and more clearly if a tighter labour markets boosts inflation and the Fed remains constraint because of government interference.

Probably never materialising – Government expenditure reductions – USD ambiguous. In a sense this is the inverse of tax cuts. Any expenditure contraction in isolation would be Dollar negative, as it would reduce growth and inflation. In contrast, if the expenditure reductions never materialises (see Section I, Problem 2), the first-order cyclical impact would be neutral as government spending remains at previous levels. The problem is fiscal sustainability concerns and the potential for markets to demand a higher term premium. We think it is quite likely that any positive cyclical Dollar impact from not cutting expenditure will be dwarfed by the negative Dollar impact arising from increased doubt about debt sustainability.

Section V. Conclusion

Overall, we would argue that the near-term impact on the Dollar is positive only when sticking to two key assumptions, namely that:

- Fiscal expansion does not lead to increased concerns about debt sustainability and
- The Fed can act freely, and in line with its current mandate, to contain inflationary pressures.

Both assumptions are questionable in the context of Trump's policy promises and preferences. In our view, it is therefore only a question of time before a myopic Dollar bullish view becomes dominated by the key issues discussed above, in particular longer-term debt sustainability concerns, worries about central bank independence, increased investment uncertainty and declining trend growth.

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