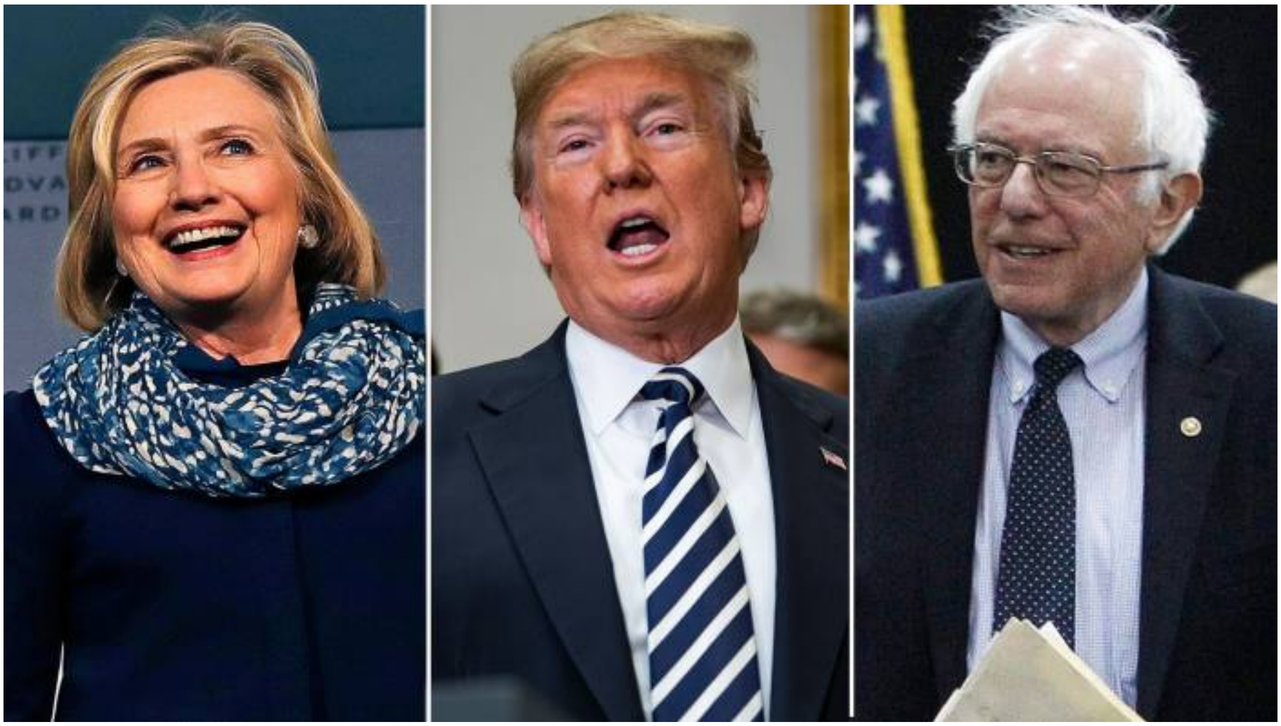
Opinion **Donald Trump**

Donald Trump is jeopardising the dollar's supremacy

Markets want the rule of law, stability and leadership. The president risks all three

EDWARD LUCE



In 2016 Hillary Clinton was at pains to show her spending priorities were funded. Donald Trump and Bernie Sanders promised Americans the moon

Edward Luce 2 HOURS AGO

At the outbreak of the first world war, investors sold dollars and bought sterling. It ought to have been the reverse, since Britain had declared war and the US was standing apart. But crowds rush to safety in a crisis — and sterling was then the reserve currency. Little did they guess that sterling would be undone by war debt.

Markets reacted the same way after the 2008 Lehman Brothers collapse. Although the crisis began on Wall Street, the dollar rose; America was rewarded for its sins. But profligacy cannot go on indefinitely. By his actions, Donald Trump is bringing forward the dollar's reckoning.

The US president's most tangible impact is on public debt. If Mr Trump's tax cuts do not expire, as they are meant to within a decade, US sovereign debt will rise from 77 per cent of gross domestic product today to 105 per cent by the end of 2028. That would roughly equal its highest level in history, which was during the second world war. By comparison, Italy's debt is 131 per cent of GDP.

Under current law, which is what the Congressional Budget Office must assume, US debt would reach 96 per cent of GDP in 10 years. In practice the only metric that counts is Washington politics, which says that temporary tax cuts are permanent.

But that understates Mr Trump's impact since it makes no allowance for a recession. At the brink of the 2007 recession, US publicly-held debt stood at 35 per cent of GDP. It more than doubled and has stayed at that level ever since. If another recession were to occur, US borrowing would have to rise much more sharply than before Mr Trump's tax cuts. He has robbed the US Treasury of ammunition it would need to fight a downturn.

That is before taking into account that the US Federal Reserve has barely started to unwind the nearly $4tn balance sheet that it accumulated as part of quantitative easing. Since the Fed is already bloated, fiscal policy would have to take up even more of the slack. Consensus forecasts put the chance of a US recession in the next two years at about one in three. It is a safe bet that if Mr Trump thinks his 2020 re-election is endangered, he would produce another large stimulus.

This is where the Democrats come in. One byproduct of Hillary Clinton's defeat was to deter Democrats from balancing the books. Mrs Clinton was at pains to show that her spending priorities were funded. Voters did not notice. Mr Trump, on the other hand, promised Americans the moon — as did Bernie Sanders, Mrs Clinton's close rival for the Democratic nomination. Democrats have drawn the natural conclusion. Should they regain control of the House of Representatives in November, conditions will be ripe for another big leap in US debt.

For years, Democrats have championed fiscal responsibility while Republicans have only pretended to. Now both rarely bother to pay even lip service. If control of America's government divides after November, the chances are that Mr Trump would push through an unfunded infrastructure bill. The US badly needs modern ports, roads, broadband and air traffic systems. In my view, they should be funded by taxes, preferably on carbon. But that is not going to happen. The only thing markets should bet on is the continued rise in US public debt.

At what point does America's broken politics risk the dollar's supremacy? All things being equal, today's mess could carry on for another decade or two. It has been building for about as long. Unlike Italy, the US has its own currency, which means it can keep printing dollars at will. Japan, which has central government debt of almost 200 per cent of GDP, shows that red ink need not trigger a crisis. But the global reserve currency must follow a higher standard than Japan's does.

As Eswar Prasad has argued, investors will keep faith in the dollar only as long as they trust the institutions behind it. The markets want the rule of law, political stability and US global leadership. Mr Trump is putting all three into question.

The world could be entering an era of multiple reserve currencies, as Barry Eichengreen predicts. This has been typical through most of history. In between the world wars, the dollar and sterling shared the stage with the French franc and the Deutschemark. Today, the rival contenders would be the Chinese renminbi and the euro. The transition could even be a smooth one. But it is also possible that the US will have a massive debt shock, caused by a war, or another 2008-scale financial meltdown. A return to protectionism might do similar damage. At that point, the dollar would cease to be king.

We cannot know which path is likelier. We do know that Mr Trump is allergic to smooth transitions.

edward.luce@ft.com

Latest on Donald Trump