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Trump border tax to pile on China capital flight pressure

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By James Saft / Reuters The “border tax” Donald Trump and Republicans are considering will spur capital flight from China, with potentially large repercussions.

House Republicans back a plan for a border tax adjustment, discussed at 20 percent, which would impose a levy on imports while granting rebates to exports.

While the Republican and Trump plans call for a border tax on all imports as a means to favor domestic production, Trump has also used the term to describe a punitive tax he threatens to levy directly on imports of companies which move production abroad. As ever with Trump, it is highly unclear what he intends or will attempt.

Trump has in the past floated the idea of a 45 percent tariff on Chinese imports to the U.S., a higher rate than is being discussed for the border tax adjustment.

For China, and for financial markets, this is going to cause trouble, and not just because it would make Chinese and other foreign imports to the U.S. less competitive.

A border tax implies a strengthening of the dollar, prompting former Treasury Secretary Lawrence Summers to warn last week of a “spike” in the greenback. All else being equal, which it seldom is, a 20 percent border tax should prompt a similarly large appreciation in the dollar. That won’t likely happen, in part because other countries will pile in with their own border taxes or other measures, but the dollar would get a sizable boost.

That poses a complex set of problems for China. Global dollar borrowing conditions would become more expensive and, importantly, pressure would intensify on the yuan to weaken in response.

“The threat to Chinese stability at a time when it is already having trouble trying to limit capital flight from a new disruption of trade is a legitimate concern,” David Levy of the Jerome Levy Forecasting Center said in an interview.

“This is not a great time from a Chinese point of view or global stability point of view to have anything that is disruptive to the flow of trade.”

One fear is that Chinese yuan owners, anticipating a dollar spike, will try to front-run the effects on the yuan, seeking to move money into other currencies or stores of value, either by following Chinese rules or by skirting them.

The yuan, which trades in a band set by China, fell by 6.6 percent against the dollar in 2016 in a self-reinforcing downdraft.

Floating the yuan

To be sure, China is not the nation most vulnerable to dollar strength. That honor belongs to emerging market countries that run a current account deficit and must attract dollars for financing.

Yet two years of strong capital outflows have depleted China’s once, and arguably still, massive foreign currency reserves. China’s reserves fell by about $320 billion to $3.011 trillion in 2016, less than the $513 billion decline of 2015 but also despite wide-ranging efforts by China to make capital flight more difficult. Seeking to circumvent capital controls, owners of yuan in China have turned to cryptocurrency Bitcoin, which more than doubled in value between September and Jan. 4. “Spot checks” on Bitcoin exchanges in China by state authorities this week sent Bitcoin down by 12 percent. At any rate, money is eager to leave by any route possible.

China still has huge FX reserves, but an IMF adequacy framework implies it needs to keep about $2.7 trillion on hand. At last year’s depletion rate we will soon be there, and if a border tax accelerates matters the issue could soon become urgent.

Asset management behemoth PIMCO said on Thursday China might float its currency in 2017. Yu Yongding, an influential former advisor to the People’s Bank of China, said on Thursday the central bank should set a “bottom line” depreciation level for the yuan in 2017 of 25 percent.

Floating the yuan would certainly be a taste of his own medicine for Trump, who has threatened to brand the country a currency manipulator. It would also, however, potentially cause a very strong outflow of capital. Foreign exchange reserves would be preserved but capital flight could become a problem, and a limit on other policies.

China is notable in that, with a semi closed economy and great central control, it has been able to stimulate its way out of various upsets during and after the financial crisis. China may find it has less room to maneuver if capital is leaving, or if the yuan depreciates greatly, with or without a float.

Remember too, all of this would be happening in and to China while most of the other emerging markets go through a crisis of similar origin.

Regardless of its impact on U.S. exports, a border tax could easily cause massive turbulence in global markets.