Macroeconomic impact series

The US presidential election

Dollar transmission important for developing economies

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Key messages

- Global financial market volatility has picked up ahead of the US presidential election as the lead of the Democratic nominee, Secretary Hillary Clinton, has narrowed.
- The US dollar has risen between 2% to 12% every year following a US presidential election since 1980 (except in 2008). A dollar rise is likely, whatever the election outcome.
- Given expectations of announced measures, the unlikely event of a Republican win would trigger risk aversion and investment outflows from developing economies deemed risky.

Looking to the US election

The US Democratic nominee, Secretary Hillary Clinton, looks set to win the US presidential election although her lead in the polls has narrowed.[1] Stock market volatility is picking up and the election outcome could have knock-on effects for developing countries through reactions in the foreign exchange markets.[2] While unlikely, a Republican win by Donald Trump could trigger a systemic shift in US economic policy and in the global markets given, among other factors, Trump's more isolationist economic policy and the failure to comply with international obligations and norms.

The economic variables most responsive to US elections – the oil price, US Treasury bond yields, US equity markets and the US dollar – could affect developing and emerging economies if they are sustained. The US dollar has risen between 2% to 12% in the year following each presidential election since 1980, except in 2008.[3] On this basis, a dollar rise is likely with either candidate. And yet, a Republican win could bring a much sharper dollar rise driven by risk aversion. This would trigger investment outflows from developing economies deemed riskier, in particular, those with larger external financing needs.

A Democratic win

Although a Democratic win is expected, the process by which this happens could have an initial dual impact. First, there could be a rise in the dollar as a result of the passing of political uncertainty that is intrinsic to this US election. The 75% probability of a Federal Reserve rate rise could increase,[4] given that residual uncertainty will have dissipated. This could support the dollar at the expense of emerging and developing currencies that are already vulnerable due to their dollar-denominated debt (such as India and Kenya) or weak commodity and oil prices (such as Zambia and Nigeria).

At the same time, a Democratic win might also see emerging and developing currencies' domestic stock markets and their exchange rates experience a 'relief rally'[5] as a result of removing the 'election risk premium' attached to the Republican nominee's protectionist and anti-immigration policies. Emerging economies with stronger trade links to the US, such as Mexico and Brazil, would benefit and see their currencies appreciate, and their portfolio investment inflows pick up.

However, Secretary Clinton's plans to support US manufacturing through trade-reducing measures, could reduce developing and emerging economy exports to the US. Though not immediate, this would eventually have an impact on developing economies' GDP. Her plans include investing $10 billion to support US manufacturing, opposing the Trans-Pacific Partnership, taking a hard-line stance on imports of China's steel and ending tax breaks for US firms that outsource jobs.[6]

A Republican win

Typically, markets have a more pronounced reaction when the party of the US presidency changes, affecting equities, US treasuries and the US dollar.[7] The event of a Trump win would see a drop in US markets because of the expected risks of announced policy changes. Risk aversion could both support the dollar, given that it strengthens during times of risk aversion, and would result in sharp declines in emerging and developing country currencies, due to investment redirected to assets that are perceived as safer. Economies with exposed financial systems, or larger external financing needs, such as South Africa, Nigeria and Kenya could see an investment downturn, as would Mexico and Brazil due to economic links with the US.

Longer-term, the US dollar could decline owing to structural changes in its trading relationships and reduced trade with emerging and developing countries. Although Mr Trump's platform is perceived as business friendly (in part, due to the pledge to cut the corporate tax rate from 35% to 15%), other policies that have been announced could sharply reduce trade with the US's top three trading partners – Mexico, Canada and China. Namely, the intention to renegotiate (or withdraw) from the North American Free Trade Agreement and the intention to label China – the largest market from which the US imports – a currency manipulator.

The relatively small share of exports in US GDP (12.6%) could limit dollar impact on trade with developing countries, particularly compared to the UK (with a 27.4% export-to-GDP share)[8] that has seen sterling lose 15% of its value[9] following the Brexit vote. And yet, a US Republican win, with its increased isolationism, would bring a deeper dollar decline in the longer term – relative to sterling's Brexit fall – given the dollar's widespread usage as a trade invoicing and reserve currency, including by oil exporters. Ultimately, a democratic win will not necessarily constitute a trade relationship without obstacles to overcome, but it would likely provide essential dollar stability, key to mitigating the transmission of shocks to developing countries.

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1. http://projects.fivethirtyeight.com/2016-election-forecast/?ex_cid=rrpromo as of Tuesday 1 November 2016.
2. Regan, J. and Haigh, A. (2016) 'Stocks drop with Mexican peso as election angst boosts yen, gold', Bloomberg, 2 November 2016.
3. Calculation based on the US Federal Reserve nominal effective exchange rate index.
4. Lange, J. (2016) 'US job growth slows; markets bet on December rate hike'. 7 October, Reuters.com
5. An increase in market prices when a key uncertainty, or risk, fails to materialise.
6. https://www.hillaryclinton.com/issues/
7. Snowberg, E., Wolfers, J. and Zitzewitz, E. (2006) 'Party Influence in Congress and the Economy'. NBER Working Paper No. 12751.
8. Statistics sourced from the World Bank.
9. Calculation based on Bank of England's sterling effective exchange rate index.

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