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WHAT I LEARNED THIS WEEK

Excerpt from December 21, 2017

2 The next breakdown in the U.S. dollar? "Never in history has one country owed so much to the rest of the world."

So wrote Joseph E. Gagnon in a post for the Peterson Institute for International Economics (piie.com) dated March 29, 2017. Gagnon, who previously served in senior positions at the U.S. Treasury Department and Federal Reserve, highlighted data from the U.S. Bureau of Economic Analysis (BEA), showing that **U.S. liabilities to foreigners exceed its assets by about $8 trillion** (the latest figures on the Net International Investment Position, or NIIP, are shown in the following charts). Russell Clark of Horseman Capital Management also weighed-in on the importance of the subject in his December 2017 letter: "Do changes in NIIP even matter? In my experience, **they tend to be good signs of potential currency weakness or of potential weakness in bonds where currency cannot make the adjustment."**

Source: U.S. Bureau of Economic Analysis

Years of financial engineering and consumption financed by consumer borrowing will loom large now that bond yields are rising. Given that a

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large share of foreign investment in the U.S. comes via the Treasury market, an increase in yields implies that **payments to foreign investors will also rise.** Gagnon elaborated:

"Borrowing from the rest of the world might have made sense if it had financed higher investment in productive capital in the United States. But, **the net debt has financed consumption not investment, as the U.S. domestic investment rate has been among the lowest of the major economies**. US domestic investment in the past 15 years averaged 21 percent of GDP, less than the world average of 24 percent and even less than investment in Japan or the euro area of 22 percent."

Gagnon also cited research from Berkeley economics professor Maurice Obstfeld and Kenneth Rogoff of Harvard, who wrote a research paper in 2000 stating that the U.S. trade deficit was not sustainable. We quote: "They estimated that returning trade to balance would require a real depreciation of the dollar of around 13 percent. Five years later, in light of the widening of the trade deficit to a record 6 percent of GDP, they calculated that **eliminating the trade deficit would require a real depreciation of around 33 percent** (Obstfeld and Rogoff 2005)."

Columbia University economics professor Jeffrey Sachs wrote an insightful article for *Project Syndicate* on April 20th headlined "Will Economic Illiteracy Trigger a Trade War?", arguing that **the prospective new tax law, which is highly likely to raise the fiscal deficit, is also likely to exacerbate the current account deficit**. He wrote: "A country runs a current-account deficit if investment exceeds national saving, and runs a surplus when investment is less than national saving. For a country with a balanced current account, a deficit can arise if its investment rate rises, its saving rate falls, or some combination of the two occurs." Sachs continued:

> *It's not hard to see why the US runs chronic current-account deficits.* ***The US national saving rate—the sum of private saving plus government saving, measured as a share of GNI—has declined markedly during the past 30 years.*** *Most of the decline in the US saving rate is due to a decline in the government saving rate.*

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Government in the US (federal, state, and local) is a net dis-saver, meaning that current outlays (for consumption, interest payments on the public debt, and transfers) exceed revenues, *currently by around 2% of GNI. This is not surprising. The lion's share of the problem is at the federal level. Every president since Ronald Reagan has promised "middle-class tax cuts" and other tax breaks, undermining revenues and leaving the federal budget in chronic deficit…*

America's trade and budget imbalances could soon get a lot worse if Trump and congressional Republicans get their way in cutting federal taxes still further. *This would be a ruinous fiscal policy, yet perhaps a popular one in the short term—before the economic bills start coming due. With a larger budget deficit,* ***America's current-account deficit would soar as well, just as it did when Reagan's tax cuts expanded the federal budget deficit sharply in the early 1980s*** *(see following chart). One can imagine that the rising trade deficit would then lead to even more outlandish claims by Trump and his officials about alleged Chinese and German trade perfidy.*

U.S. Current Account Balance, 1980-2021E (percent of GDP)

Note: Dashed line is forecast starting in 2017.
Sources: IMF, World Economic Outlook database; Cline (2016); and PIIE.

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The Wall Street Journal of December 19th carried an article headlined "Tax Plan's Impact: Narrower Trade Gap," which argued that by curtailing the shifting of corporate profits to low-tax jurisdictions, the new tax bill could result in a lower trade deficit. However, Brad Setser, senior fellow at the Council on Foreign Relations (CFR), recently argued that **despite this potential change in corporate behavior, the current account balance is not likely to change**.

In his December 6th article for the CFR headlined "Tax Reform and the Trade Balance," he wrote:

"Remember that the balance-of-payments effect of a lot of tax strategies has been to improve the income balance (by raising the reported profitability of U.S. firms abroad relative to the profitability of foreign firms in the U.S.) while increasing the trade deficit (by encouraging the importation of high value components from low tax jurisdictions and reducing reported exports of intangibles and high value components). Reversing these strategies consequently will change the measured trade balance but not the current account balance: the income surplus from FDI earnings abroad relative to foreign earnings in the U.S. will fall as the trade balance improves."

The preceding analysis points to **rising U.S. fiscal deficits, a falling rate of national savings, higher bond yields, rising current account deficits and a weaker U.S. dollar.** The GOP tax bill has been advertised as a "growth enhancing" bill, but non-partisan analyses raise serious doubts about this claim (see section 12). If the anticipated growth fails to materialize, then fiscal deficits are going to widen even more than expected and bond yields are likely to move higher, while a falling dollar will raise inflation and tighten the squeeze on consumers.

In Horseman Capital's letter, Russell Clark elaborated: "**Given higher rates, and the potential for more rate increases in the U.S., why has [the dollar] not strengthened?** What have investors seen that is worrying them about the US dollar? Perhaps [it] is the deterioration in the US fiscal deficit despite strong asset prices and very low unemployment. A deteriorating U.S. fiscal deficit tends to indicate inflection points for the U.S. dollar (see chart below)."

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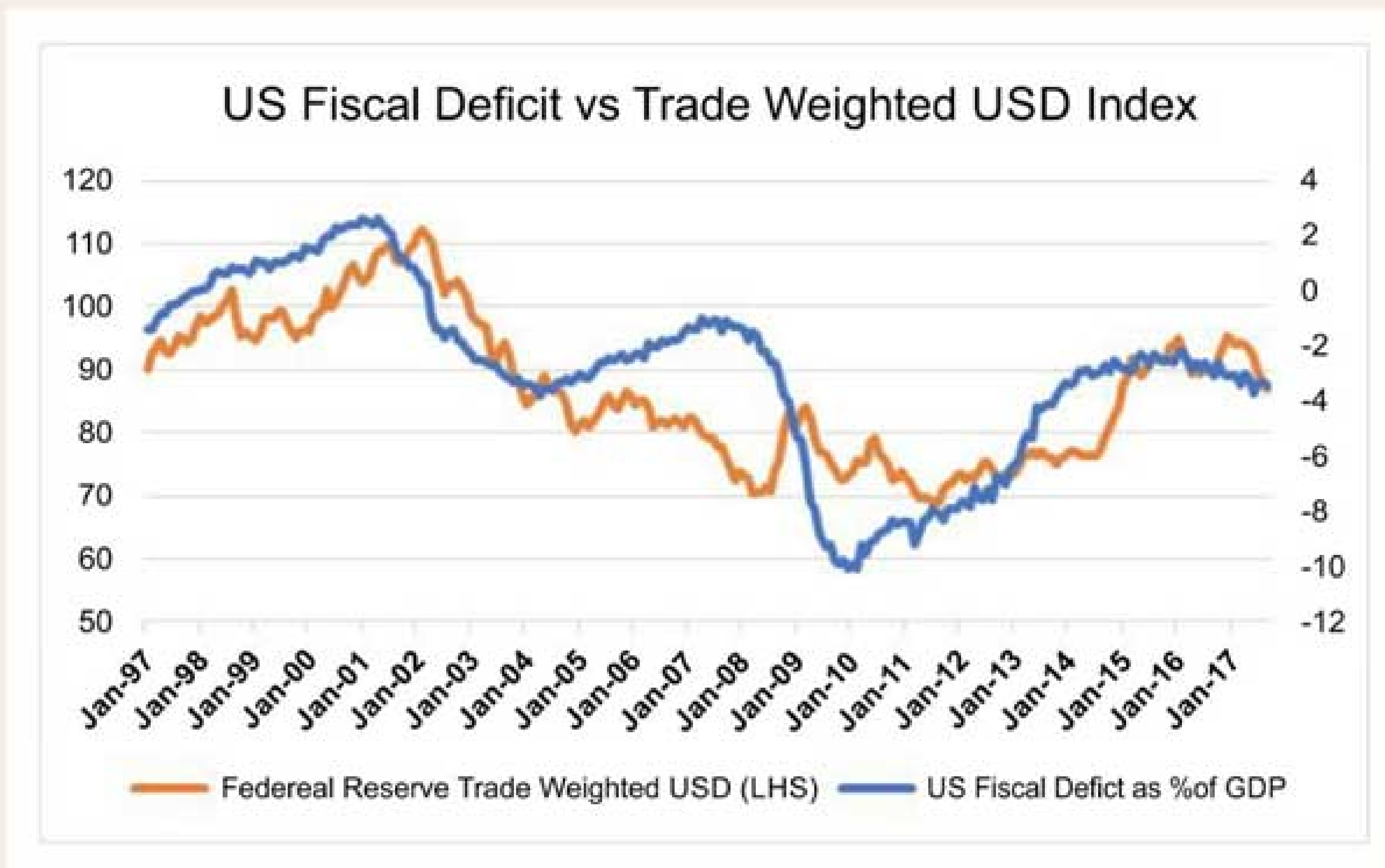

Source: Horseman Capital Management

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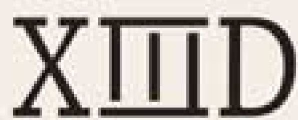

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