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Reflections on Domestic Policy and American Hegemony: Part I

(Due to the Easter holiday, our next report will be published April 29.)

The dollar is the world's reserve currency. As such, there is a constant demand for dollars from foreign countries to provide liquidity for global transactions. Because of the reserve currency status, U.S. monetary and fiscal policy affects the world economy in ways that other nations' policies do not. The Federal Reserve is the U.S. central bank; in its mandate, it only concerns itself with the U.S. economy unless overseas events directly affect America. In general, the Federal Reserve would not be allowed to cut U.S. interest rates to boost the Canadian economy. Fiscal policymakers almost never worry about the impact of spending or taxes on foreign economies. However, U.S. monetary and fiscal policy can affect foreign economies through access to the reserve currency and trade.

Previous reports have discussed the reserve currency role. Recent policy decisions and potential Federal Reserve governor appointments could have a dramatic impact on monetary and fiscal policy. At the same time, because of America's superpower status and its role in providing the reserve currency, these policy actions will also impact foreign economies. ***The key issue is the degree to which the U.S. can use hegemony to force domestic economic adjustments on foreigners.***

In Part I of this report we will review the basis of the reserve currency role and the impact of the savings identity. In Part II, we will examine the power of hegemony by historical comparison, using the Nixon and Reagan administrations as analogs. In Part III, we will examine how the Trump administration is using American power to force foreign economies to absorb at least part of the economic adjustment. Our normal analysis of potential market ramifications will conclude the third installment.

The Reserve Currency as a Public Good

Economists define a public good as a product or service that must be provided by governments because the private market won't provide the good or will only provide the good in less than optimal amounts. There are seven public goods a reserve currency nation should provide:

1. Act as consumer (importer) of last resort;
2. Coordinate global macroeconomic policies;
3. Support a stable system of exchange rates;
4. Act as lender of last resort;
5. Provide counter-cyclical long-term lending;
6. Provide a truly riskless AAA asset for benchmarking purposes;
7. Supply deep and predictable financial markets.

Charles Kindleberger, the famous economist who studied asset bubbles, identified the first five public goods and Mohamad El-Erian, chief economic adviser at Allianz, added the last two.

In practical terms, what does providing the reserve currency mean? Here is a simple example. Imagine that a chocolatier in Paraguay wants to purchase a ton of cocoa beans. He calls a dealer in Côte d'Ivoire for a price; the seller offers \$2,450 per ton. The buyer in Paraguay notes he does not have U.S. dollars but does have Paraguayan guaraní.

The seller could accept Paraguayan currency but would be disinclined to do so because it isn't widely accepted. He would likely be restricted to one of two decisions. First, he could use the guaraní to buy goods from Paraguay. Although that outcome makes the trade somewhat better than barter, the cocoa dealer may not find anything he wants in Paraguay. Or, he could invest the guaraní in Paraguayan financial assets. However, he may not be all that comfortable taking on the risk in Paraguayan financial markets.

On the other hand, if the cocoa dealer received dollars, he would have a currency that is widely accepted worldwide and could be used to purchase a plethora of goods and services. And, if the dealer decided to invest the proceeds, he would have the deep and well-regulated U.S. financial markets at his disposal.

So, taking our example further, how does the chocolatier in Paraguay get dollars? The most efficient way would be to export chocolate to a U.S. buyer, then use the dollars he receives to buy cocoa beans from Côte d'Ivoire. Because the reserve currency has widespread acceptance, non-reserve currency nations have an incentive to run trade surpluses with the reserve currency nation to accumulate the reserve currency, which allows them to pay for imports from around the world.

The Bank for International Settlements (BIS) reports that more than 80% of trade-related letters of credit are denominated in U.S. dollars, significantly more than the second most used reserve currency, the euro, at 10%.¹ That means most global trade is conducted in dollars, usually between nations other than the U.S. ***Essentially, the reserve currency nation must run constant trade and current account deficits in order to provide liquidity for global trade.*** Thus, the U.S. doesn't run trade deficits because we "under-save," as is often heard by pundits in the financial media. Strictly speaking, this is true but it is mostly in response to foreign nations over-saving and moving that saving to the U.S. in the form of exports. If the U.S. were to run persistent trade surpluses, it would act as a global monetary tightening. In other words, by pulling dollars from world markets, the global trading system would face a contraction of available liquidity. If the reserve currency nation refuses to provide enough of its home currency to global markets, world trade is effectively reduced to barter, or countertrade, meaning that nations can only engage in bilateral trade relations. Using the above example, the Paraguayan chocolatier can only acquire cocoa beans from Côte d'Ivoire if the seller there has something specific he would like to swap from Paraguay. Simply put, global trade would fall sharply if a reserve currency is unavailable.

Economist Robert Triffin described the reserve currency country problem in the 1960s. Because the reserve currency provides global liquidity, the reserve currency country must run a persistent current account (trade) deficit. As noted above, if the reserve currency nation runs a surplus, it would act as a global monetary

¹ <http://www.bis.org/publ/cgfs50.htm>

policy tightening. However, this deficit would need to be “manageable.” If it becomes too large, it could shake foreign investors’ confidence in whether the risk-free asset is truly risk-free.

The benefits of providing the reserve currency are rather simple; the reserve currency nation receives goods and services from the world in exchange for its currency. In effect, the U.S. exports dollars (and Treasuries for reserve purposes) and imports goods and services. And, when foreigners receive dollars, they can use them to buy U.S. goods and services, but they can also use them to buy goods and services from other nations. If they don’t want to spend their dollars immediately, they can hold them in U.S. financial assets. Thus, their investing tends to lower U.S. interest rates and boost the value of other financial assets as well.

A benefit of this arrangement is that the U.S. can essentially print the foreign reserve currency and it has great value. The downside is that the reserve currency requires the U.S. to accept trade deficits and trade arrangements that are, by structure, unfair. Consequently, being the reserve currency nation leads to lower inflation but higher unemployment than would occur otherwise.

The Savings Identity

The savings identity explains the process.

$$0 = (I-S) + (G-T_x) + (X-M)$$

I = Domestic Investment

S = Household + Business Saving

G = Government Spending

T_x = Taxes

X = Exports

M = Imports

Or, the net of private sector domestic saving less private sector domestic investment, plus the fiscal account plus the current account equals zero. If foreigners need dollars it means the U.S. economy must run a trade deficit, or $M > X$. For the equation to balance, either the government must run a deficit, $G > T_x$, or the private sector must over-save relative to investment, or $I > S$. A current account deficit is the same as importing foreign saving. The influx of foreign saving must be absorbed by a private sector investment/saving deficit or a fiscal deficit. ***It is critically important to note that the direction of causality cannot be determined by this equation.***

Often, one will hear pundits on financial media suggesting the U.S. runs a current account (mostly trade) deficit because we under-save relative to government spending or domestic investment. Although functionally true, the causal factor could also be the foreign demand for the reserve currency. If the U.S. is open to trade and foreign nations deliberately over-save by restraining domestic consumption (leading to $S > I$), or run fiscal surpluses ($T_x > G$), then according to this identity the U.S. will run a current account deficit through no moral failing of U.S. households, businesses or government.

Typically, a nation can only fund endless current account deficits that are caused by either private sector under-saving or government under-saving to the extent that foreigners are willing to fund the deficit. That desire mostly depends on the perceived creditworthiness of the nation. However, in the case of the U.S., where the dollar is used for both reserves and international trade, the desire for dollars is great enough that nations are willing to skew their economies to run trade surpluses to accumulate dollars. Thus, non-reserve currency nations have an

incentive to either run private sector surpluses ($S > I$) or government surpluses ($T_x > G$) so that $X > M$. As long as the U.S. is willing to accept persistent current account deficits, then the system works fairly well. The key, however, is the willingness of the U.S. to accept such deficits.

Part II

The next report will offer a historical perspective on America's ability to force economic adjustment on foreign nations. Due to the Easter holiday, the next edition will be published on April 29.

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