Weekly Geopolitical Report

By Bill O'Grady

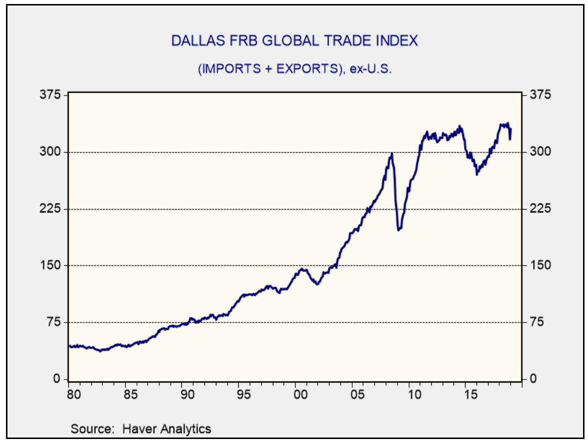
May 6, 2019

Reflections on Domestic Policy and American Hegemony: Part III

Part I of this report was a review of the reserve currency and the savings identity. In Part II, we showed how the Nixon and Reagan administrations used America's hegemonic power to force some of the economic adjustment of U.S. policy onto foreign governments. This week, in the final segment of this report, we will look at the actions of the Trump administration, using the comparisons to the Nixon and Reagan administrations. We will conclude the report with market ramifications.

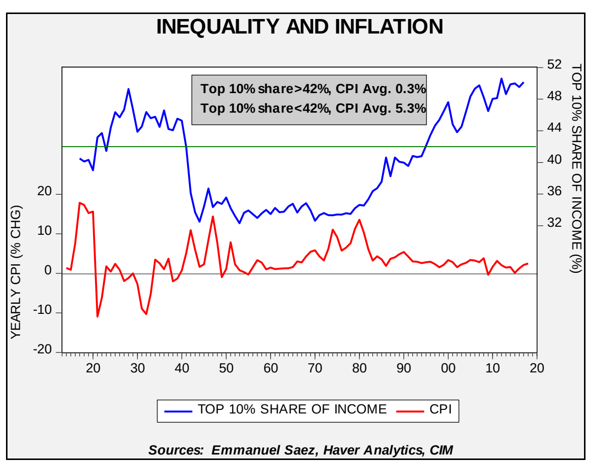
The Trump Analog

Nixon's decision to end Bretton Woods, as noted in Part II, turned Treasuries into gold, and led to foreign nations systematically engaging in practices designed to run trade surpluses with the U.S. to acquire dollars. Reagan's policy of deregulation and globalization, coupled with the transformation of Treasuries into reserve assets, exposed U.S. industries to persistent, aggressive foreign competition. U.S. policy from subsequent administrations supported the steady expansion of global trade.



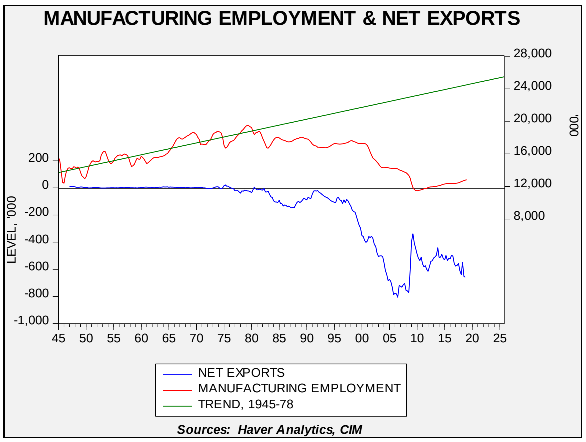
This chart shows the combined import and export indices for the world, ex-U.S. Note the steady upward growth that accelerated after 2000 when China entered the WTO. World trade growth depends on the U.S. providing the reserve currency. As a result, trade growth depends on U.S. consumption.

As we have demonstrated, deregulation and globalization did reduce inflation. However, automation (which is allowed under conditions of deregulation) and trade competition tend to increase inequality. And, the data show that increasing inequality coincides with low inflation.



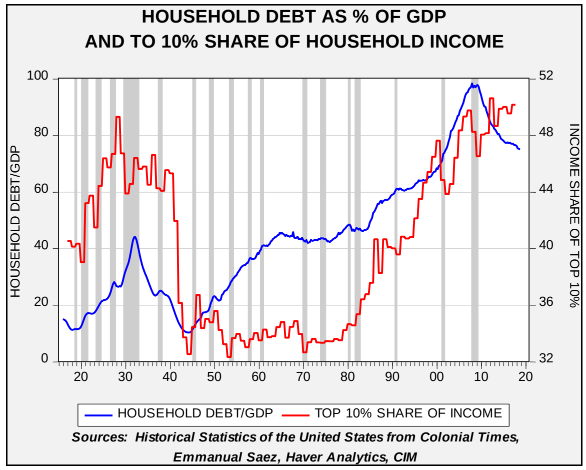
The above chart shows the top 10% of households' share of national income. The "pivot point" appears to be 42%; when the top 10% share is less than 42%, inflation is significantly higher. When above 42%, inflation is much less. One way of thinking about this issue is that one person's efficiency is another person's lost job.

The impact of deregulation and globalization can be seen on U.S. manufacturing employment.



The upper line shows the level of manufacturing employment. We have regressed a time trend through the data for the period of 1945-78. In other words, if manufacturing employment had stayed on that period's trend, the level of manufacturing employment would be approximately 24.5 million rather than the current 12.8 million. Manufacturing employment was traditionally a path to the middle class. The jobs tended to pay well relative to their skill levels. Deregulation and globalization have caused a drop in manufacturing employment, weakening this avenue for advancement.

Rising inequality undercuts the ability of the American consumer to act as global importer of last resort. What we saw, at least until the Great Financial Crisis, was that increasing household debt offset the impact of rising inequality on consumption.

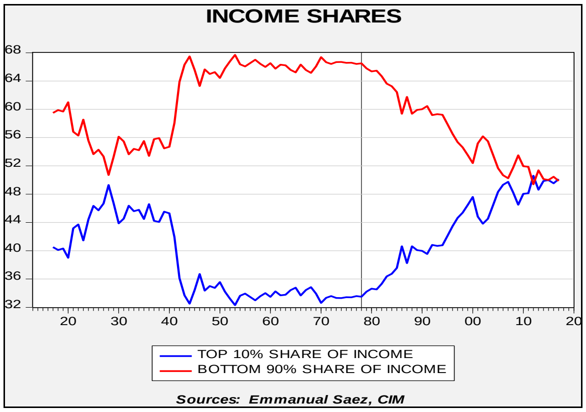


This chart shows household debt from 1915 along with the top 10% share of income. From the 1920s into the Great Depression, household debt rose along with inequality. The Second World War was, from a financial standpoint, a massive private sector/public sector debt swap. In general, household debt/GDP around 40% appears manageable. However, debt began to rise as inequality rose beginning in the early 1980s and supply side policies began to take hold. It continued to rise along with inequality until the 2008 Financial Crisis. Although households have been deleveraging, inequality remains elevated.

Rising U.S. household debt levels have tracked the expansion of global trade.

Note that since U.S. households began deleveraging, the expansion of global trade has stalled.

Inequality has become a serious problem.

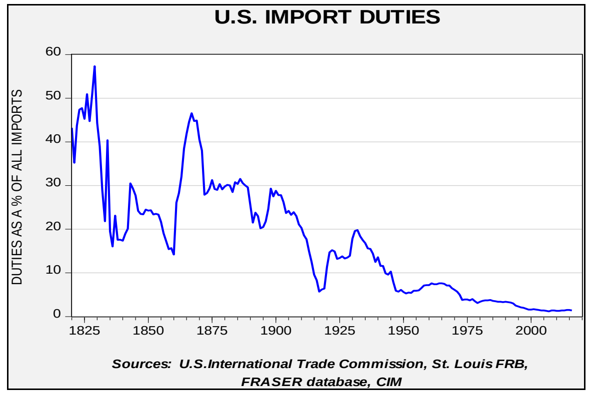


Currently, the top 10% are collecting the same level of income as the bottom 90%. These are the conditions that have led to the rise of populism in the U.S. This trend in American society probably can't continue indefinitely.

President Trump's campaign in 2016 targeted some of the issues surrounding income inequality. His emphasis has been on reversing globalization; so far, the administration has supported continued deregulation. This policy direction has focused on two areas, reducing the trade deficit and limiting immigration. Although both affect financial markets, the trade issue is probably more important in the short run.

The president has changed existing trade policy in two directions. The first is by moving to bilateral from multilateral trade negotiations. The U.S., given its size and power, will always have the upper hand in bilateral trade negotiations. During the Cold War era, America tended to engage in multilateral trade talks to encourage other nations to support the geopolitical isolation of the communist bloc. However, with the Cold War clearly over, the U.S. can exercise greater power through bilateral pacts.

The second change is the use of tariffs to force foreign nations to change their behavior.

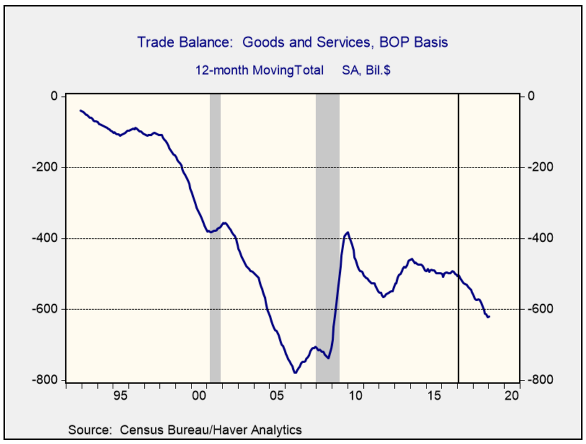


This chart shows U.S. import duties applied to all imports. The percentage has been in a clear downtrend for years. In fact, the last time the U.S. significantly ratcheted up tariffs was in the 1920s prior to the Great Depression. Since the 1930s, the level of tariffs has steadily declined.

Tariffs have tended to become less popular over time for three reasons. First, during the period after WWII, fears of a return to "beggar thy neighbor" policies that were thought to have worsened the Great Depression prompted an avoidance of new tariffs. Second, the U.S.-led trade regime for the Free World used GATT and the WTO to adjudicate trade disputes and reduce retaliatory tariffs.

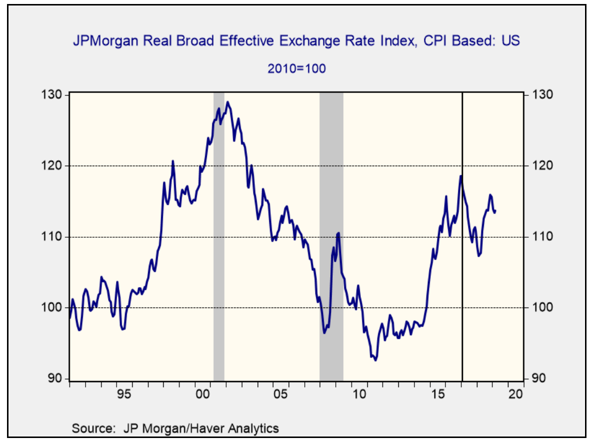
The third, and probably most important, reason that tariffs have fallen from favor is floating exchange rates. With floating exchange rates, under normal circumstances, a widening trade deficit will lead to a weaker currency. However, if this persists, the weaker currency will reverse the trend. If a nation were to use tariffs to narrow the trade deficit, it would likely lead its currency to strengthen, diminishing or negating the impact of the tariff.

At this point, the Trump administration has renegotiated trade relations with Canada and Mexico (USMCA) and with South Korea. The U.S. is also in talks with Japan, China and the EU to address the trade deficit. The threat of tariffs does appear to be focusing U.S. trading partners on adjusting earlier agreements; however, there is little evidence that the trade deficit has improved.



This chart shows the rolling 12-month goods and services deficit. We added a vertical line representing the Trump administration's inauguration. Although weaker growth abroad relative to U.S. growth does affect the relationship, there is no concrete evidence that the Trump administration's trade policy has improved the trade balance.

President Trump is trying to boost U.S. employment and growth while reducing inequality and, like Presidents Nixon and Reagan, Trump wants to force at least some of the adjustment onto foreign economies. Up to now, he has used the threat of tariffs to force the adjustment. Part of the reason the Trump administration has struggled with achieving this goal is the strength of the dollar.



This chart shows the JPM dollar index. Initially after Trump took power, the dollar weakened. However, the dollar recovered after the administration moved to apply tariffs on trading partners to force the renegotiation of trade relations.

So far, the Trump administration has mostly shunned overt actions to weaken the dollar. However, this is where relations between the Federal Reserve and the administration become important. From the time when the U.S. central bank became independent of the Treasury in March 1951,[1] presidents have often had an uneasy relationship with the central bank. We have already noted the Nixon administration's conflict with Arthur Burns. President Johnson nearly came to physical blows with Chair Martin.[2] President Reagan "ordered" Chair Volcker to avoid raising rates into the 1984 election.[3] President George H.W. Bush threatened Chair Greenspan in the 1988 election[4] and later blamed Greenspan for his loss to Bill Clinton in the 1992 election.[5] During the

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[1] https://www.federalreservehistory.org/essays/treasury_fed_accord
[2] https://www.nytimes.com/2017/06/13/business/economy/a-president-at-war-with-his-fed-chief-5-decades-before-trump.html
[3] https://www.businessinsider.com/ronald-reagan-fed-chair-volcker-trump-2018-10
[4] Op cit., Mallaby, pp. 366, 372-374
[5] Ibid., pp. 415-417

Clinton administration, a detente was established between the Federal Reserve and the White House.[6] Treasury Secretary Rubin convinced President Clinton that criticizing the Fed's conduct of monetary policy was counterproductive because it would just frighten the bond market.[7]

Although this peace accord held through the George W. Bush and Barack Obama administrations, it has been broken by President Trump. The current incumbent has been relentless in his criticism of monetary policy and has recently recommended two loyalists to open governor positions on the FOMC. As we noted with the Nixon administration, when the independence of the Federal Reserve is seen as compromised, the dollar will tend to weaken, all else held equal. It is likely that President Trump's overt goal of weighing on the Fed is to encourage policy accommodation. But, an unexpected effect of undermining the U.S. central bank's independence would be a weaker dollar.

What does President Trump want? It appears he wants to increase U.S. employment, especially manufacturing employment, by reducing imports.[8] Increasing such employment will boost U.S. growth at the expense of our trading partners. But, as we have seen, dollar strength appears to be thwarting this goal.

Referring to the savings identity:

$$0 = (I\text{-}S) + (G\text{-}Tx) + (X\text{-}M)$$

To increase X (exports) relative to M (imports), the U.S. must increase either private saving relative to investment or narrow the fiscal deficit. Given recent tax cuts, public sector saving probably won't rise. Thus, private sector saving must rise. One way to make that occur is to weaken the dollar. The rise in import prices will tend to depress consumption and lift household saving. Under fixed exchange rates, tariffs would accomplish this goal by raising import prices. Under floating exchange rates, tariffs will likely lead to a stronger dollar; thus, overt polices to weaken the dollar might be more effective.

Undermining the Federal Reserve could undermine confidence in the dollar and support a narrower trade deficit. Paradoxically, that might mean backing away from tariffs. If foreigners still want dollars, they will tend to weaken their exchange rates to offset the effect of tariffs. But, a deliberate policy to depress the dollar would essentially force the adjustment of increasing U.S. employment onto foreign nations. ***If President Trump wants to shift some of the adjustment costs of addressing inequality to foreign nations, a weaker dollar, rather than tariffs, would probably be more effective.*** As Nixon found, a less independent Federal Reserve would probably aid this effort.

As Nixon and Reagan showed, America's superpower status allows the U.S. to force the adjustment overseas. Other nations lack the power to avoid this change. The risk is that U.S. power may have weakened enough that the world may refuse to cooperate. Although possible, there isn't much evidence to suggest that any other nation is prepared to accept the burden of hegemony. Therefore, President Trump will likely have some success in forcing some of the economic adjustment abroad.

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[6] Ibid., pp. 436-445.

[7] This was the situation behind James Carville's famous quote that when he dies he wants to come back as the bond market "because you can intimidate anybody." https://en.wikiquote.org/wiki/James_Carville

[8] The fact that Peter Navarro is an in-house advisor supports this position.

Ramifications

Oscar Wilde was quoted as saying, "When the gods wish to punish us, they answer our prayers."[9] The downsides to Nixon's policy changes were higher oil prices and uncontrolled inflation. The downsides to Reagan's exercise of power were currency volatility, a collapse in oil prices, an equity market crash in 1987,[10] a widening trade deficit and increasing inequality. If Trump's policies are successful, what would be the market effects?

We would expect a weaker dollar, higher inflation and higher commodity prices. The key trigger to that outcome will be the dollar. So far, the administration has not taken steps to press for depreciation. At some point, however, we do expect the president and his advisors to move in this direction, simply because it is the most effective policy for narrowing the trade deficit. Undermining the independence of the Federal Reserve, which appears to be underway, would support this effort.

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[9] https://www.brainyquote.com/quotes/oscar_wilde_139151

[10] A threat from Treasury Secretary Baker to push the dollar lower if Germany didn't stimulate its economy was one of the contributing factors to the 1987 crash.

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