Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

By Bill O'Grady

September 16, 2019

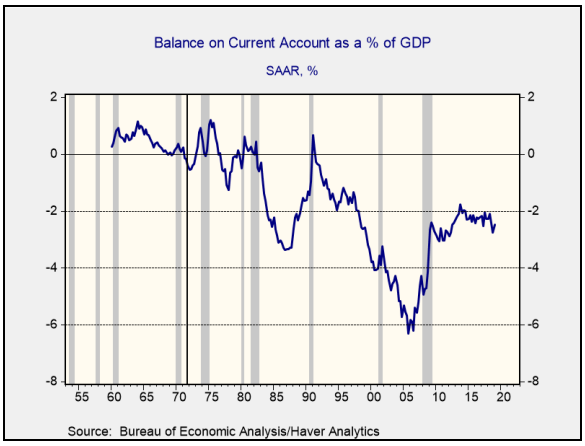
Weaponizing the Dollar: The Nuclear Option, Part I

Last month, we wrote a two-part report on weaponizing the dollar.[1] The continued strength of the dollar has become newsworthy recently, prompting us to provide an update to those earlier reports and include an analysis of groundbreaking new legislation that was introduced in the Senate.

In Part I of this report, we will review the U.S. current account problem and examine how that persistent deficit affects the economy. We will also include how the U.S. current account deficit is tied to American hegemony and the way the deficit could be addressed. In Part II, we will introduce the Competitive Dollar for Jobs and Prosperity Act (CDJPA). Along with details of the proposed law, we will introduce the macroeconomics of the CDJPA and discuss how it would affect the dollar's reserve currency status. We will then examine the potential political effects of the bill, the likely retaliation from foreign nations and, as always, conclude with potential market ramifications.

The Current Account Problem

Since the U.S. left the gold standard in the early 1970s, current account deficits have become the norm.



This chart shows the U.S. current account deficit relative to GDP. The current account is a broad measure of "current" international flows and includes trade in goods and services, net investment income from abroad and net remittances. The bulk of the account comes from trade. Here is a table showing the data for Q1.

Current Account	-130.4	
Trade		-154.6
Net Income		61.1
Net Remittances		-36.9

The negative components are trade, as the U.S. runs a persistent trade deficit, and net remittances, as the large foreign-born population tends to "send money home." On the other hand, U.S. investments abroad are positive and have been reducing the current account deficit most years since the early 1970s.

On the above chart, we have placed a vertical line at the point where President Nixon removed the U.S. from the Bretton Woods gold standard. Although not every quarter has a deficit, since that decision,

[1] See WGRs, Weaponizing the Dollar: Part I (8/12/19) and Part II (8/19/19).

surpluses have only occurred 12.6% of the time. And, since, 1980, there have only been nine quarters where the current account was positive, or only 5.7% of the time.

To better understand the current account situation, a review of the macroeconomics of the current account should help.[2] The basics for this analysis is the savings identity:[3]

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

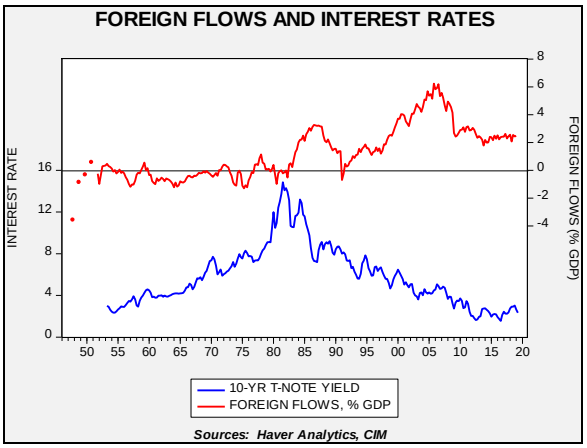
Or:

Private net saving + public net saving + foreign net saving (the current account) is always equal to zero.

Because this relationship is an identity, it is always true but only in the same way a balance sheet always balances. If the U.S. is running current account deficits, then the identity is M>X, or that variable has a negative sign. To offset this outcome, the U.S. must either run a fiscal deficit (G>Tx) or a private sector deficit (I>S).

The key issue raised by this identity is the direction of causality behind the current account deficit. It is possible that the U.S. undersaves—our fiscal deficit or our lack of private saving relative to investment is what causes the current account deficit to occur. This chain of causality would suggest that the U.S. undersaves and thus needs foreign saving to balance the identity. This is the most common reason espoused in the mainstream financial media. However, in a world where trade and capital flows are open, it is just as likely that foreign behavior drives the current account deficit. In other words, if foreign nations deliberately oversave (underconsume) their behavior will result in excess saving that will need to find a home. The most likely home is in the country that provides the reserve currency. Accordingly, it is just as possible that the U.S. current account deficit is due to excessive foreign saving, the result of policy decisions made abroad.

Is there any way of knowing which may be the causal factor? If the U.S. had a shortage of saving, it would seem that interest rates in the U.S. should rise to attract foreign saving. In other words, a widening current account should lead to higher interest rates. The chart below compares the inflows of foreign saving and the 10-year T-note yield. In fact, foreign flows (the inverse of the current account deficit) have been rising as interest rates have declined. Although comparative interest rates abroad may affect this relationship, it would seem fairly obvious that the U.S. hasn't needed to raise rates to attract foreign saving. This situation would suggest that the current account deficit isn't caused by American's profligacy but foreigner miserliness.



Is the Current Account Deficit an Economic Problem?

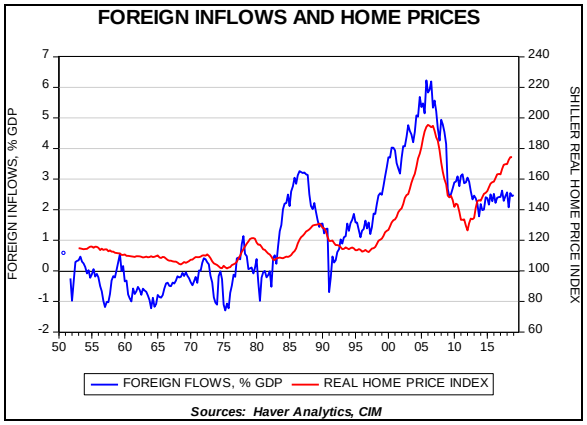
As is often the case with economic issues, where one stands on an issue depends on where one sits! In other words, the current

[2] For background, see our earlier WGR series, *Reflections on Trade*, Parts 1, 2, 3, 4.

[3] Savings identity components: investment (I), saving (S), government consumption (G), taxes (Tx) and net exports (X-M).

account deficit is a negative for some but a benefit to others. There are clear benefits to a current account deficit. Foreign saving, without countervailing actions by the central bank, will otherwise tend to lead to lower interest rates. The inflows, in the form of goods and services, provides U.S. consumers with ample competitively priced goods, which tends to reduce inflation.

On the negative side, foreign saving will tend to reduce employment in the U.S. due to import competition. It can also lead to distortions in financial markets; the influx of saving can lead to excessive borrowing and overvalued asset markets. The chart below shows foreign inflows and inflation-adjusted home prices. It would suggest that last decade's home price bubble was likely supported by excessive foreign saving. It can also exacerbate inequality.



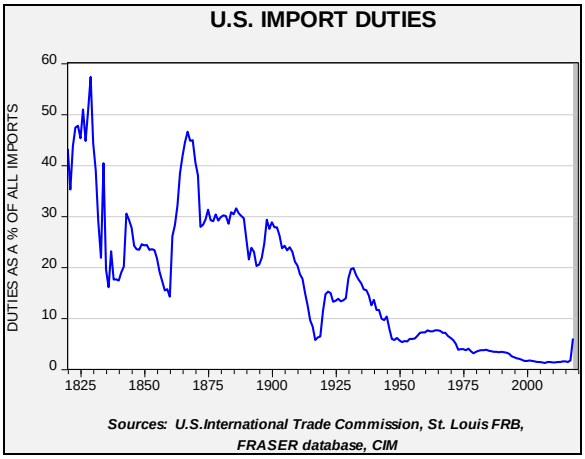
In general, the nation running a current account deficit is supplying aggregate demand to nations running current account surpluses. This is why, at Bretton Woods, John Maynard Keynes wanted to create a system that penalized nations that ran excessive current account deficits and surpluses, thus encouraging nations to stay near balanced trade. The U.S., which was a surplus nation at that time, scotched that idea.

The Superpower Issue

A complicating matter for the U.S. current account deficit is that America, in its role as global hegemon, supplies the reserve currency. Thus, every nation in the world wants to acquire dollars, mostly via a bilateral trade surplus with the U.S. This means the U.S. must run a current account deficit to supply dollars for global trade. The U.S. does not want nations that purposely oversave as a matter of policy to absorb U.S. domestic demand. In other words, if the current account deficit is deemed a problem, the U.S. wants to fix it by changing the behavior of foreign policymakers.

Fixing the Problem

If U.S. policymakers decide that the current account deficit needs to be addressed, they need to develop an effective policy response. The Trump administration has deployed tariffs in an attempt to reduce the trade deficit.



This chart shows the value of import duties as a percentage of all imports. Note that tariff levels have been declining since the Smoot-Hawley Tariff of 1930. In the aftermath of Bretton Woods, which led to floating exchange rates, tariffs fell again. This is due, in part, to the fact that floating exchange rates reduce the impact of tariffs; as tariffs increase, countries usually respond

with currency depreciation. This action offsets at least part of the impact of tariffs. The gray area of the chart represents our estimate of the administration's tariff impact. It would be a notable increase if the proposed tariffs are fully implemented.

The use of tariffs works off the assumption that the problem is underpriced imports. In some cases, that might be true; "dumping" is the term where a nation exports goods to another nation below the cost of production. Although this action clearly benefits consumers in the importing nation, it harms workers that compete in the industry. On the other hand, the issue with imports might not be merely that they are underpriced. It may be that the good or service is unavailable in the domestic market.

Other than tariffs, there is another possible policy direction. To some extent, Treasury debt is the most desirable export the U.S. has. It is liquid, safe and pays a positive nominal interest rate. The interest is paid in the reserve currency, which is universally accepted. It is unique to the U.S.; no other nation offers an equivalent instrument with all the features of a T-bond. If the Treasury were a product, the U.S. would probably be running large trade surpluses. But, because it is a financial instrument and is routed through the capital account, "exports" of Treasuries, by definition, end up as current account deficits. The easiest way to acquire Treasuries is to run a trade surplus with the U.S. Thus, one way to reduce the inflows of foreign saving is to restrict access to Treasuries. Another tactic would be to combine capital restrictions with a policy of currency depreciation through active monetary policy.

Part II

Next week, we will introduce the Competitive Dollar for Jobs and Prosperity Act (CDJPA). We will outline the details of the proposed law and discuss how the macroeconomics of the CDJPA would affect the dollar's reserve currency status. We will then examine the potential political effects of the bill and the likely retaliation from foreign nations. Finally, we will conclude with potential market ramifications.

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