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Trump & Trade: The First Year

President Trump has been in office for just over one year, having been inaugurated on January 20, 2017. He campaigned on a populist agenda—anti-globalism was a core message. Specifically, his “America First” mantra railed against free trade deals, suggesting they were poorly negotiated, supported immigration restrictions and called on allies to shoulder more of their defense burdens.

In this report, we are going to focus on the trade situation following his first year in office. We will begin with a review of American hegemony and trade, including how trade is affected by saving patterns both in the U.S. and abroad. This analysis will include commentary on the effects of fiscal policy on administration trade policy, showing how they are working at cross purposes. One critically important aspect of administration trade policy is how foreign nations react to the threat of tariffs and sanctions. We will argue that the administration’s goal should be employment and show how foreign companies may be adjusting to Trump’s policies in a way that won’t help narrow the trade deficit but could improve the job market. As always, we will conclude with potential market ramifications.

American Hegemony and Trade

Hegemonic Stability Theory¹ argues that the world functions best when there is a single

dominant global power that maintains global stability. Kindleberger suggested that the primary cause of the Great Depression was the fact that Britain was losing the ability to act as global hegemon and the U.S. was unwilling to accept the role. The subsequent power vacuum led to the calamities of the first half of the 20th century.

The theory suggests that the hegemon supports world political and economic stability by providing two broad global public goods. The first is military security. This always involves protection of trade routes, both on land and at sea, with the latter being the most important in the last millennia. The second public good is to provide a reserve currency, a global medium of exchange that facilitates global trade and economic stability.

Hegemons throughout history have provided these public goods in different ways. Imperialism was a common response; colonies not only gave the superpower’s navy areas to establish bases, but they also provided markets for trade that the hegemon could dominate for its own needs. The reserve currency was usually provided by precious metals; although the hegemon may not have had complete control over the production of precious metals, supporting a metal currency regime prevented the hegemon from over-expanding the money supply and causing inflation.

The U.S. accepted the hegemonic role during WWII; the arrangements made at Bretton Woods meant the dollar became the

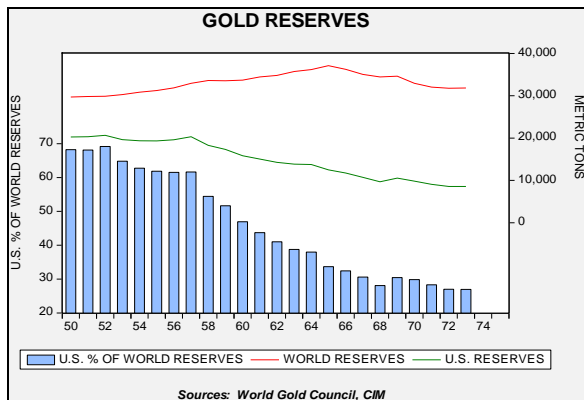
¹ The seminal book on this topic comes from Charles Kindleberger. Kindleberger, C. (1986). *The World in*

Depression, 1929-1939 (2nd ed.). Berkeley, CA: University of California Press.

free world’s reserve currency. Unlike previous hegemony, the U.S. did not embrace imperialism. America’s founding as a breakaway colony generally undermined imperialism in the U.S., although there was some imperialist activity during the administration of Theodore Roosevelt. Instead of colonies, the U.S. set up treaty organizations that facilitated the establishment of military bases around the world.

To provide the reserve currency, the Bretton Woods system fixed exchange rates to the dollar and fixed the dollar to gold at \$35 per ounce, creating a dollar/gold reserve system. At the time of the agreement, the U.S. economy was dominant; it represented over 35% of global GDP. Much of the developed world was devastated from the destruction of WWII. Within a few years after the war, the Soviet Union closed off the communist bloc and those nations generally used countertrade² or used the ruble. Thus, the burden of providing the reserve currency was somewhat reduced because the dollar wasn’t used in the communist nations.

In the early years of the Bretton Woods system, the U.S. held 70% of the world’s gold reserves. However, as time passed, the amount of gold dwindled.



This chart shows gold reserves for the U.S. and the world. Note that gold reserves steadily declined from the late 1950s into the 1970s.

The problem for the reserve currency was discussed by an economist named Robert Triffin, who detailed what became known as the “Triffin dilemma.” The problem is that the reserve currency nation has to run a trade deficit in order to provide global liquidity for foreign trade. If the reserve currency nation runs a trade surplus, it would shrink the availability of the dollar on global markets and lead to slower global growth.³

However, there was a risk that if the trade deficit became too large, foreign nations would lose faith in the reserve currency, potentially leading to a crisis. To prevent a crisis, the reserve currency nation may be forced to reduce the trade deficit through austerity. Unfortunately, the process of improving confidence would come at the expense of slower global growth as the reduced trade deficit or a surplus would reduce the global supply of the reserve currency.⁴

The Bretton Woods system tried to maintain faith in the dollar by tying it to gold. However, as the above chart shows, gold reserves fell as global trade rose. European nations, which were holding an increasing store of dollars, began demanding gold, creating a crisis. President Nixon faced an unenviable choice in 1971—implement austerity by tightening fiscal and monetary

³ The Bank of International Settlements notes that over 80% of trade-related letters of credit are denominated in USD. See: <https://www.bis.org/publ/cgfs50.pdf>, page 13.

⁴ It should be noted that Triffin described his dilemma during the Bretton Woods period, which had fixed exchange rates. Another obvious solution to this dilemma would be depreciation.

² A form of barter in international trade.

policies, reversing the gold flow but likely causing a recession, or close the gold window and threaten the dollar's reserve status. Nixon, worried that austerity would undermine his chances at re-election in 1972, closed the gold window. In the ensuing months, the fixed exchange rate system ended and exchange rates began to float. Floating exchange rates shifted the burden of adjustment from the trade deficit nations to the trade surplus nations. Under Bretton Woods and a fixed exchange rate system (and the gold standard that preceded it), a trade deficit would lead to a lack of gold. This would force up interest rates, slow the economy and narrow the trade deficit. Under floating rates, a trade deficit nation's currency would depreciate (at least in theory), reducing the price of its exports. Meanwhile, the trade surplus nation would see its currency appreciate, making its exports less competitive, causing the imbalance to correct itself.

Nixon's decision could have spelled an end to the dollar's reserve role. Instead, it freed the dollar from the gold link and transformed the reserve system from dollar/gold to dollar/Treasury. In other words, countries found they had no viable alternative to the U.S. dollar for reserve purposes. However, they now had to park their reserve assets in some other financial instrument other than gold. Treasuries became the preferred reserve asset which led to a significant change in how the reserve currency role was managed.

Unwittingly, Nixon changed the international system in such a way that the U.S. was essentially rewarded by running fiscal and trade deficits. As the world economy grew, the demand for dollars rose as well. This encouraged foreign nations to run increasingly larger trade deficits with the

U.S. in order to acquire dollars to operate in the global economy.

As time passed and the global economy became increasingly integrated, the dollar/Treasury reserve system caused severe distortions to the U.S. economy... and, arguably, to the global economy as well. In the U.S., sectors facing direct foreign competition struggled to remain competitive. Foreign competition, "unfair" by design, forced U.S. firms to outsource and automate to stay profitable. However, foreign nations that built their manufacturing bases were able to produce goods at more competitive prices than in the U.S. due to weaker regulations and the easy transfer of technology abroad.⁵ This gutted American manufacturing employment as U.S. firms created fewer jobs. At the same time, industries that facilitated imports, such as transportation and logistics, grew. And, financial services, which recycled global saving that occurred due to foreign trade surpluses, also prospered.

Foreign nations' economies were distorted in the opposite direction. Due to the need to accumulate dollars, they purposely restrained consumption, forcing the household sector to save. They used this saving to build excess capacity that created an export sector that sold to the U.S. to facilitate the acquisition of dollars. This development model, called export promotion, became the dominant development model in the postwar era.

⁵ See Richard Baldwin's book for a thorough analysis of the technology transfer process. Baldwin, R. (2016). *The Great Convergence: Information Technology and the New Globalization*. Cambridge, MA: Harvard University Press.

The Economics of Trade⁶

In macroeconomics, there is an identity that states:

$$0 = \text{private saving} + \text{public saving} + \text{foreign saving}$$

$$\text{Private saving} = (\text{household income} - \text{consumption}) + (\text{business saving} - \text{investment})$$

$$\text{Public saving} = \text{government spending} - \text{taxes}$$

$$\text{Foreign saving} = \text{exports} - \text{imports}$$

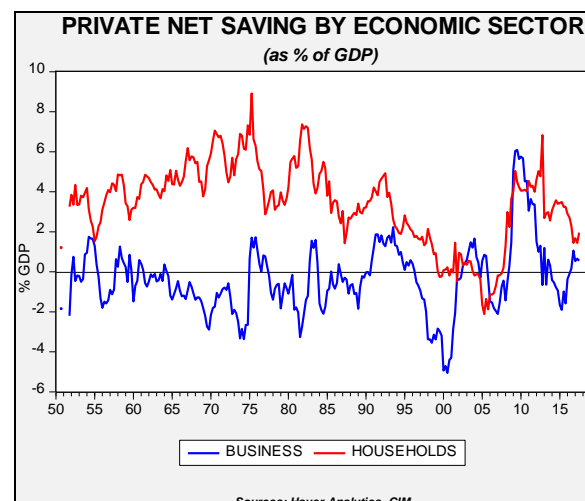
Thus, if a nation runs a trade surplus (positive foreign saving), it must run an equivalent negative balance in either the public or private sector. Thus, either private saving must exceed private investment or the government must run a fiscal surplus.

Under conditions of free trade, if a nation purposely creates foreign saving (a trade surplus), then some other nation must absorb this saving and run a trade deficit. If free trade conditions don't exist, then the nation running a trade surplus will simply be forced to add private sector investment in excess of private saving or run a fiscal deficit. In other words, under conditions of trade protection, there is no incentive to force a trade surplus (foreign saving) by either forcing up private saving relative to private investment or running a public surplus.

To win the Cold War, the U.S. accepted the reserve currency role which necessitates accepting imports. Especially under the dollar/Treasury reserve system, this meant that trade deficits had to be absorbed by either a private or public sector deficit. The U.S. tended to do both. Fiscal deficits

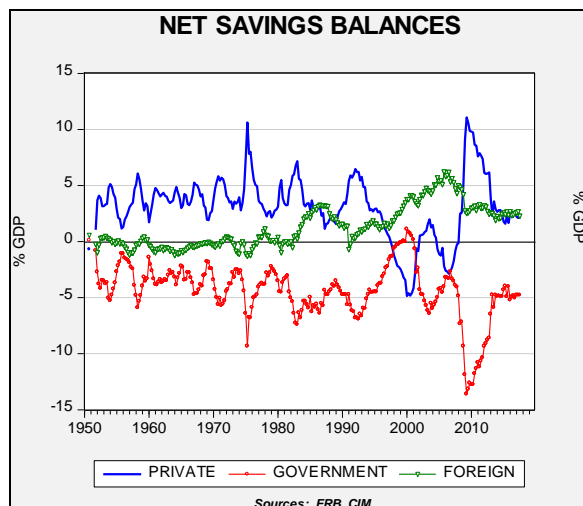
became very common after 1980 and falling private saving, especially from the household sector, led to private investment often exceeding private saving.

The chart below shows net private saving as a percentage of GDP. Households were mostly net savers until the turn of the century. However, the level of household saving to GDP peaked in 1975, shortly after the U.S. broke the gold standard (see above). Household saving steadily declined over the next three decades, becoming negative in 2003. The business sector was usually a dis saver, which is normal; in fact, it is preferable for businesses to face the test of the financial markets when investing because the cost of capital is more transparent. Internally funded investment sometimes carries the risk of malinvestment because it isn't measured against the rigors of the financial markets.



Here are the net saving data for the three sectors of the U.S., scaled by GDP.

⁶ For an in-depth discussion of trade economics, see WGR, Reflections on Trade, [Parts I-IV](#).



Until the early 1980s, foreign saving (the inverse of the current account) was a negligible part of the U.S. economy. The fiscal deficit was funded by the U.S. private sector. However, the rising fiscal deficits of the Reagan years, coupled with the expansion of export promotion and the influx of foreign saving, led to rising investment and falling household saving. The fiscal surplus of the second Clinton term and the influx of foreign saving from China led to massive private sector dissaving, much of which went into the equity bubble in the technology sector.

A couple of items emerge from the data. First, private sector saving and public sector dissaving coincide with recessions. During recessions, households and businesses curtail spending, leading to rising private saving. This must be offset by either (a) a fiscal deficit, (b) a trade surplus (the export of saving to foreigners), or (c) a combination of the two. Since the U.S. is the reserve currency nation, (b) isn't really an option. Thus, fiscal deficits tend to widen during recessions. They fall during recoveries as private sector saving falls as spending increases.

Trump's Choices

If the U.S. were to jettison the reserve currency role, it could put up trade barriers, forcing the foreign saving sector into negative territory. To offset the negative saving, either the government would need to run a surplus or the private sector would need to increase saving. The former would be fiscal austerity, the latter would be falling consumption relative to income from households (slower growth) or a decline in business investment relative to business saving, also slowing growth.

These are not good choices because they all involve slowing growth. Remember, the fastest way to boost private sector saving is to have a recession and the simplest way to run fiscal surpluses is to raise taxes.⁷ A trade surplus from slower growth isn't what any political figure wants.

What the president should want is job growth. A high level of employment is the goal of anyone in office. This is where trade protection comes into play. Recently, the president announced tariffs on washing machines and solar panels. Foreign firms in these industries have either opened production facilities in the U.S. or are planning to do so.⁸ This action will not necessarily reduce the trade deficit. But, it will almost certainly create U.S. jobs.

⁷ On the fiscal side, it isn't the only way. Another way is to have an economy expand to the point where revenue soars. This was partly what led to the Clinton surpluses. However, the "peace dividend," which cut defense spending (in retrospect, a really bad idea), constrained government spending and led to the surplus.

⁸<http://www.foxbusiness.com/features/2018/01/29/chinese-firm-announces-u-s-solar-plant-week-after-trump-tariffs.html> and <http://www.straitstimes.com/world/united-states/how-asian-giants-can-counter-trumps-washing-machine-tariffs>

The recent tax cut will exacerbate this issue. As the fiscal deficit widens, it must be funded by either private or foreign saving. The latter, in the form of investment from abroad, allows for the tax cuts to support the economy. The downside? A wider trade deficit.

Ramifications

One of our concerns about the administration's trade policy was the fear that it would put up significant trade barriers. If the trade impediments are strict enough, it could conceivably lead to rising price levels and undermine financial asset values.

It is still possible that the president could trigger a trade war with China. He could unilaterally end NAFTA. These actions would add some jobs in the U.S. but also bring notable disruption to the U.S. economy. On the other hand, as we have attempted to demonstrate, if the president's goal is to increase jobs (and maintain the elevated levels of the current equity markets), it would make sense to use protectionist threats to press foreign companies to invest in the U.S.

There are two potential risks to the strategy. First, protectionist acts may sway small

nations to cooperate with the U.S. and encourage their firms to invest in the U.S., even if it reduces employment in the foreign nation. This effect would be amplified if the foreign nation is dependent upon the U.S. for security. However, it may not be as effective with a large nation like China. China is large enough to push back against American protectionism. This could take the form of disrupting supply chains or threatening U.S. financial markets by cutting Treasury purchases. Some of these threats are real (China could affect global supply activity), others less so (China would have to accept financial losses and potentially higher unemployment if it stopped buying Treasuries). Second, there is a risk that foreign investment may not significantly boost employment. If the greenfield investment in plant and equipment is heavily automated, the impact on hiring may be paltry.

So far, this administration's populist rhetoric has not matched its actions. Using trade protection to foster foreign investment in the U.S. may be another element of this pattern.

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