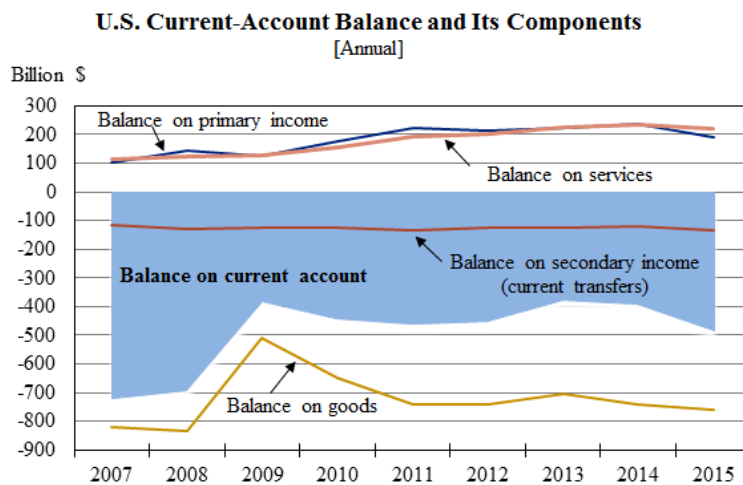


One Deficit Too Many

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Prior to this election season Americans used to pay about as much attention to trade and current account deficits as they did to picking potato chips, and with good reason. Economists have been warning for years that America's trade issues would come back and bite us in the keister, but so far, nothing seriously detrimental has occurred. In fact, the U.S. current account deficit declined to \$125.3 billion or 2.8% of GDP in the final quarter of 2015. Notwithstanding the sheer nominal dollar size of that deficit, 2.8% of GDP is less than many other countries and significantly smaller than 2006 when we reached a run rate of 6% of GDP. (1)



Bureau of Economic Analysis - U.S. Department of Commerce

In 1965, when we imported much less, manufacturing accounted for 53 percent of the U.S. economy. By 2015, substantial portions of our manufacturing base had moved overseas and domestic manufacturing had shrunk to just 12 percent and only 9 percent of employment. Since 1976, despite 10.6 trillion dollars of the largest cumulative balance of payment deficit in world history and a plunge in manufacturing as a share of our economy, we have seemingly persevered without a definitive penalty. So, do trade and balance of payments deficits really matter?

Yes, they matter immeasurably.

In the long run, no country that has run perennial trade deficits, imported and borrowed more than it exported or lent, has seen its currency live to tell about it. In fact, before the Roman Empire fell, the Roman Senate sneered at criticism that carts brought Rome imported goods from all over the world but departed with only manure.

For the past 30 years, the primary objective in the reduction of trade barriers has been to boost the standard of living for billions across the globe. This has worked particularly well for China, Southeast Asia, India and Mexico, among others. The motivating principal was that when restrictions are reduced and each nation's comparative advantage augments international trade, we see an efficiency of production resulting in increased consumption along with lower prices. One country more efficient at making cars and another more efficient at making pharmaceuticals are both better off when they trade. As a result, their economies grow more.

As an ardent free trade, free enterprise and open markets advocate I have found it difficult to entertain any thoughts contrary to these principles. However, every once in a great while there comes a time to recognize an exception, a time when economic facts dictate considering solutions that may be against these strongly held beliefs.

The U.S. has now run a current account deficit for 40 years and recently its net international investment position has also deteriorated from a negative 1.4 trillion in 2008 to a negative 7.3 trillion in 2015, or close to 40% of GDP. (2)

Chart 1. U.S. Net International Investment Position, 2007:IV-2015:III
(Quarterly, not seasonally adjusted)



U.S. Department of Commerce – Bureau of Economic Analysis

Nevertheless, many analysts often focus only on the latest quarter's trade deficits and disregard the fact that an annual current account deficit of \$400-500 billion dollars becomes a cumulative deficit of 4-5 trillion in only 10 years. It is the cumulative aspects of trade deficits that matter, the long forgotten trade deficits of 1988, 2006, 2015 and everything in between.

Herbert Stein correctly noted, "If something cannot go on forever, it will stop." but many following U.S., trade and current account deficits believe they may be the living example of Keynes's time proven adage "In the long run we are all dead." Nevertheless, the approaching danger is that the longer America's trade deficits go on, the greater the crisis when they cease, voluntarily or involuntarily. History has repeated shown that the ramifications of a profligacy in imprudence often occur when least expected. The 2008 housing crisis is a case in point.

To comprehend the potential plight of the U.S. dollar we must understand its relationship to our status as the world's primary reserve currency. Despite losing 97 % of its purchasing power since the creation of the Federal Reserve, the U.S. dollar today is still the world's leading currency. More countries use the dollar for reserves than any other currency. It is also the most likely choice as an alternative or substitute currency. Furthermore, the U.S. is unique in that more than 50% of its currency is distributed throughout the world for functions unrelated to claims on U.S. production or trade.⁽³⁾ The euro, the pound and the yen are distant competitors.

This grandeur bestows wide ranging privileges on the American people, privileges that would not be available under similar circumstances or with similar trade deficits for, say, the Argentines, Poles, Brazilians or any other country whose currency is not considered a reserve. The dollar's exalted position in world finance provides Americans with benefits that extend well past its role as a financial reserve, it translates directly into available hard consumable products for the U.S. public at artificially low prices.

Because the U.S. dollar is commonly held as a means of exchange and lending between independent third parties, and not as much as a claim on U.S. production, Americans get the benefit of the float. This results in an ability to borrow because of an artificial demand for dollars that keeps its relative price far higher than it should be, certainly given 40 years of trade deficits. Lower import prices on a wide range of goods inhibits domestic manufacturing but it affords the American public imported goods in large quantities. Regrettably, given the relative decline in U.S. manufacturing, this reserve status now relies more on America's historical post war supremacy, the dollar's standing ubiquity and the absence of a substitute currency, rather than its current industrial might. Like Blanche Dubois, the U.S. dollar has become a currency dependant on the kindness of strangers, though they may not always be so kind.

Reserve currency status can also short-circuit the natural laws of trade. Under conventional circumstances when a country runs a trade deficit for a long time, other countries begin to liquidate that currency because they can reasonably envision that the trade deficit country will have to print more money to pay for its imports. They correctly anticipate that the excess supply of money will reduce the purchasing and exchange value of the trade debtor's currency. Thus, as the currency declines in relative value, the higher price for imported products usually means that the trade debtor country will have limits in the number of imports it can afford. However, all things being equal, it also means that the trade debtor's now lower priced currency should increase demand for its exports and rectify problem trade deficits through a natural self-correcting mechanism.

Unfortunately, in the case of the U.S. dollar, that process has been circumvented and we have sown the seeds of a time bomb. Because of its reserve currency status and the dollar's elevated value, U.S. exports are more expensive than they should be and as a result U.S. production jobs are exported to low wage countries from industrial states like Pennsylvania, Indiana, Ohio, Michigan, Wisconsin and Illinois. This results in higher unemployment and lower wages for American industrial workers and potential political turmoil.

The current U.S. election cycle has demonstrated that some things have truly changed. The American worker now sees the ramifications in the rapid arbitrage of international wages

and world trade and he believes it has put him out of work. He now feels, and not unreasonably so, that one way or another too many of our international trading partners are not playing fair. These competitors use their wage rate advantage to readily export to an open U.S. market and then compound that advantage by also instituting byzantine currency and regulatory methods to restrain U.S. exports.

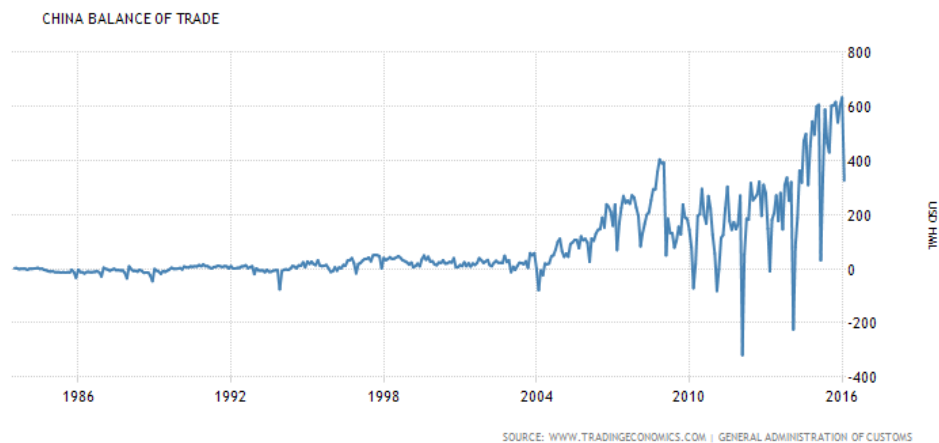
Fair competition between near equals in wage compensation can result in a drive to innovate with new processes and systems that improve productivity in production. For example, arbitraging a U.S. hourly wage of \$30 (U.S.) with a Canadian wage rate of \$25 dollars (U.S.) can force improvement to American efficiency. However, some differentials are just too difficult to overcome. It becomes almost impossible to retain domestic U.S. manufacturers that must pay a Delphi Auto Parts worker \$49.00 an hour while at the same time competitors are outsourcing to Vietnamese workers paid .96 cents/hr (4). If enough high-paying industry jobs move offshore, the mitigated wages paid by the remaining employers such as Radio Shack and McDonalds and others can mean lower aggregate demand, mitigated savings and investment and ultimately a weaker economy.

Don't misunderstand, international competition, be it in wages or products, is generally a good thing. It pushes countries to focus on their comparative advantages and therefore improve production. If the Japanese auto industry had not put such an emphasis on quality, Detroit might still be designing cars with planned obsolescence or even now Detroit might be making cars that are "unsafe at any speed." The problem is that many U.S. trading partners have taken clandestine and inequitable competition to a new level and for the more open U.S. markets the resulting trade deficits have become a sucker's game. Many American companies have found that they are disadvantaged in competing against foreign countries that don't require safety or environmental regulations. Many competitors also underprice their currencies, free companies from health care costs through their own government paid health programs, provide subsidies for investment in land, buildings, energy, equipment, grant tax holidays and rebates, provide subsidized financing or pay their workers subsistence wages that would be illegal in the United States. The end result is that America is de-industrializing a sizeable part of the manufacturing base that it has painstakingly built over the past 150 years.

America now produces fewer real products and imports more per capita because investment and capital are not welcome here anymore. Regulations, taxes, litigation, labor for value costs, poor educational skills, entitlements and ridiculous healthcare costs have chased manufacturing out and foreign locales with less of each have welcomed it in. This corporate and capital flight has diminished the number of quality investment and job opportunities which has exacerbated income inequality, weakened consumer credit and mitigated aggregate demand. Ironically, all of this has provoked calls from more radical candidates for even more of the same socialist prescriptions of higher taxes and more regulation that precipitated the problem in the first place. Clearly, we are forgetting that the ramifications of a prolificacy in imprudence often occur when least expected. The 2008 housing crisis is a case in point.

A large portion of the U.S. trade deficits are now with China and since 1995, China has also consistently recorded trade surpluses with the rest of the world. Since just 2009, China's trade surpluses have increased more than 10 fold.(5) Consequently, when some economists

grumble about an undervalued Chinese yuan, they do so with the valid assertion that, over the long term, the Chinese currency has not risen proportionally to China's growth in per capita wealth, GDP or trade surplus.



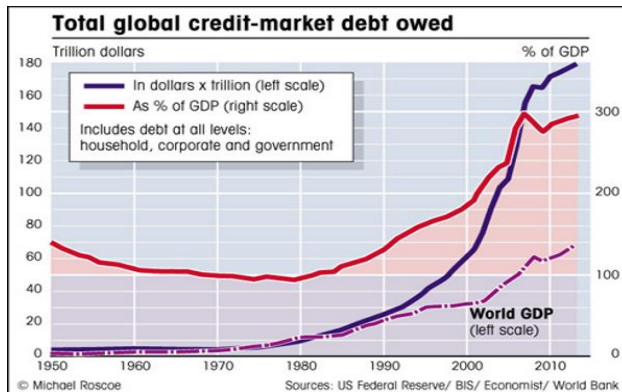
Despite the relative decline in manufacturing, some argue that the U.S. balance of payments deficit at 2.8% of GDP is not excessive and therefore there is not really an urgent reason to act. However, the real problem is not the calculation of trade relative to GDP. It is the definition of U.S. GDP. When services are the lion's share of an economy as they are in the U.S., the trade imbalance in real products matters much more. In fact, many "services" are not particularly accretive to the real U.S. economy and bring little in the way of hard currency to balance the red ink when compared to more manufacturing based economies like Japan, Germany and China. For example, tennis lessons, nail salons and casinos are not really a sign of a productive economy but more an indication that the U.S. is simply moving money around. Consequently, when calculating our balance of payments deficit relative to our GDP, we need to subtract those portions of the economy that fail to add real value and see our real dependence on externally manufactured products for what it is, a much more menacing proposition.

The big danger is that in one year or five, we will experience just one 40 billion dollar monthly current account deficit too many, one that culminates in a dollar collapse. Can we predict that date or the precipitating factor? Not likely.

Perhaps it will stem from yet another QE because, for the umpteenth time, our debt, regulatory, tax burden or declining monetary velocity has again deflated the U.S. economy. Perhaps there will be precipitous defaults in some sectors of the world's massive debt structure or in the multitude of new covenant-lite corporate debt, or possibly fallout from defaults in the student loan market. Maybe it will simply derive from an unexpected transformation in psychology rather than an economic event.

Whatever the factor, the first symptom is apt to be a decline in the dollar that extends in greater duration and magnitude than the economic climate would dictate. Economists will be mystified. Multivariate regressions and inference algorithms will fail to explain the abrupt drop because we will be catching up, paying penance for those long decades of trade and budget deficits. It will suddenly become clear that the dollar's post World War II ubiquity is retracing.

In fact, on that day the dollar will bear more than just a passing resemblance to Wile E. Coyote who, having run out of road, alternates between contemplation of his audience and the canyon far below. On that day, nothing will save the dollar, not the corporate profits offshore, not more Japanese purchases of U.S. Treasuries, not presidential jawboning, nothing. The Federal Reserve will also be powerless because in a weak economy the difficulty of subtracting dollars from the system will pale in comparison to the ease of adding them.



Federal Reserve Bank of St. Louis

At the outset, the degree of upward pricing will overwhelm even the best of optimists and there will be a substantial increase in the price of imported products across the board. Faced with a loss of his favorite German, Japanese, Korean, Chinese and Vietnamese products, the American consumer will now turn from the significantly higher priced imports to domestically manufactured products. The Toyota that was close in price to the Chevy will double and as a result the U.S. consumer will rapidly devour all outstanding inventories of Chevys. Unfortunately, when prices rise more, the U.S. consumer will become the low tender. Enhanced foreign purchasing power due to a declining dollar will bid up for U.S. products and the American buyer will be priced out of his own production. Overall inflation for most products will then soar and demand from both Americans and foreigners will overrun supply. Additionally, foreign investors will now buy up U.S. farmland, mines and other industries on the cheap. Understandably, it is hard to imagine such a scenario in today's deflationary economy.

Nevertheless, unable to afford imported good, Americans will seek shoes only to find they are not made in America. They will search for televisions, only to find, they are not made in America. They will ruefully realize that the same applies to Rawlings baseballs, Gerber Baby Food, Etch a Sketch's, Converse Shoes, stainless steel rebar, dress shirts, Mattel toys, minivans, vending machines, Levi Jeans, Radio Flyer's red wagon, cell phones, railroad turnouts, Dell Computers, canned sardines, forks, spoons and knives, incandescent light bulbs..... Americans will wistfully wonder where their manufacturing base went and how they lost over 63,000 factories just since the year 2000. (6)

Our consolation: waste product and waste paper will continue as our largest export and we will sell more of it. It won't be Roman manure but you won't be able to tell the difference.

In attempting to borrow and increase production, American producers will find they have too much debt from too many stock buybacks. Making matters worse, producers only expand

production and add supply if the return on their invested capital is higher than their cost of capital. It won't be. Exogenously derived inflation and commensurately higher interest rates, all in conjunction with higher dollar priced raw materials and commodities will cause costs to exceed those potential ROIs restraining new supply. In addition, the vast majority of foreign made machine tools will be economically unaffordable to many U.S. producers. In turn, foreign lenders, anticipating an even further dollar decline, will demand an expanding rate premium over inflation. Investors will seek refuge in gold and other currencies rather than production. In conjunction with the need to print money to ameliorate debt, there will be a mad dash to salvage any remnants of one's purchasing power and that will supplant any proclivity to invest. America will be boxed-in.

Therefore, America needs a plan now that will mitigate future long-term trade and budget deficits, an overall blueprint where everyone is better off, including our trading partners.

Part I - Balancing Trade

I propose that when the U.S. runs a trade deficit with any country for five years, an automatic import limit comes into play in the sixth year mandating a reduction in the trade deficit with that specific country by 20%. A 10% increase in American exports and a 10% decrease in imports relative to that country would fit the bill, but either way, an additional 20% annually mandated reduction in the trade deficit would continue for four more years until trade is balanced. Then, the law would again go into hibernation for five years allowing free trade with that country to resume. No tariffs, just a country specific trade deficit limit that acts as a current account safety mechanism that reduces the dangers of de-industrialization.

This gradualist method would also insure that our trading partner's interests would now be aligned with ours, providing them with a strong incentive to buy more American products. As a result, they would bring to bear innovative solutions on how to import more of our products so that they could export more of theirs. Ultimately, this would be a much firmer foundation for world trade.

Part II – Return to Fundamentals

Modifications in our trade policy are not the only changes needed for the U.S. economy to improve. The second part of a comprehensive plan would require significant reductions in corporate and personal income taxes, government spending and entitlements. A flat tax of 22% at the Federal level with a maximum combined state and local income tax of 4% would revive U.S. fortunes better than any single factor. It is no coincidence that Hong Kong, with a maximum 16% income tax rate, has over the long term consistently been one of the world's best performing economies.

Furthermore, there would need to be significant mitigations in the regulatory and environmental stranglehold on industry and we would also need to closely monitor unreasonable and spurious demands from U.S. labor so that we don't engender more outcomes like the City of Detroit when U.S. manufacturing revives. On balance, controls on crony capitalism and corporate lobbying would also need palliations. In the end though, rising U.S. high value factory

production would increase the number of higher paying jobs and U.S. workers would again become consumers of tangible U.S. made products. This would result in improved aggregate demand, savings, and investment resulting in greater prosperity for the U.S. economy.

It is clear that if we fail to take these actions, our long-term trade deficits alongside our cumulative budget deficits will eventually destroy many of our remaining industries as well as our military.

Forty years of trade deficits might lead one to agree with what we are told; that trade deficits, like budget deficits, don't really matter. But as Rudiger Dornbusch commented; "In economics, things take longer to happen than you think they will, and then they happen much faster than you thought they could."

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- 1) U.S. Department of Commerce - Bureau of Economic Analysis
 - 2) U.S. Department of Commerce – Bureau of Economic Analysis
 - 3) U.S. Treasury International Capital, Z-1 Report
 - 4) Government of China - General Administration of Customs
 - 5) General Statistics Office Government of Vietnam 2015
 - 6) Alliance for American Manufacturing