

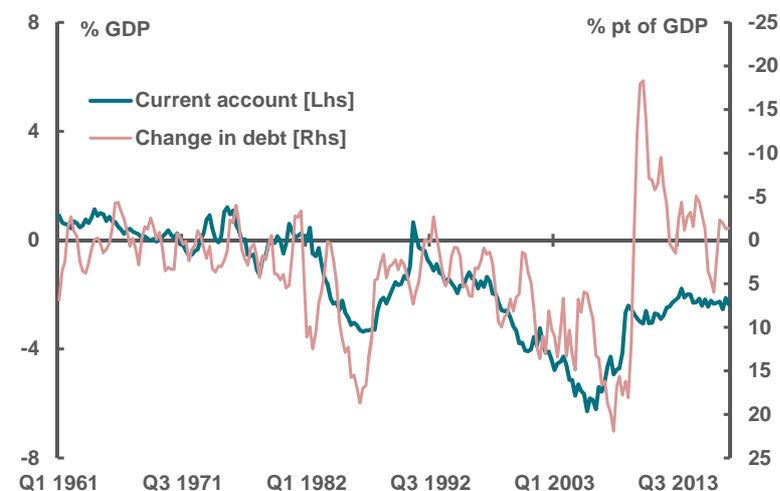
US deficits and the dollar

The current account deficit should depreciate the dollar, but only over the longer-term

Key points

- US total indebtedness is set to rise over the coming years, but should remain below the 2008 highs. The composition of the debt will be more skewed to the public sector.
- The US current account deficit is currently at 2.5% of GDP. This is somewhere in the middle of the historic range. We consider this somewhat elevated and expect it to rise over the coming years, worsening the US's net international investment position.
- The rising current account deficit and international indebtedness should create a downward bias for the dollar, but only over the longer-term (2-3 years).
- Cyclical factors presently support the dollar. As these fade over the coming year, we expect negative structural factors to weigh increasingly heavily.
- Our review of US indebtedness does not suggest a malign build-up of financial imbalances that look poised to precipitate the next downturn.
- Yet elevated leverage increases US economic fragility, which is likely to exacerbate any economic downturn that materialises over the coming years.

Exhibit 1
Changes in US indebtedness and the current account deficit
US current account and indebtedness



Source: US Bureau of Economic Analysis (BEA), Federal Reserve Bank (FRB) and AXA IM R&IS calculations

Total indebtedness set to rise

We have published two papers considering the scale of US indebtedness. In the first¹, we considered the significant and unchecked rise envisioned for US Federal indebtedness. In the second², we examined the pick-up in corporate indebtedness, concluding that this was less alarming than headlines might suggest and likely to diminish over the coming years in response to tax reforms and market conditions.

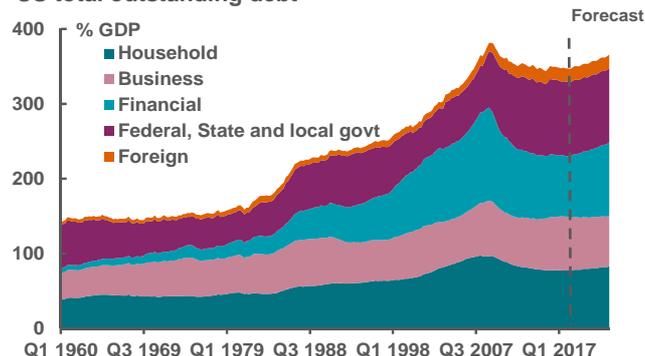
Combining our forecasts, we envisage a rise in the level of government indebtedness to around 100% of GDP over the coming years. However, we expect business indebtedness to fall back to 68% of GDP over the same period, from 72% at present. This will largely be the result of planned deleveraging as tax reforms and rising interest rates reduce incentives for corporate debt. We also consider the likelihood of a modest rise in household and financial borrowing as deregulation eases some of the post-crisis restrictions on mortgage lending specifically. While the scale of this impact is uncertain, we model a pace of household credit growth similar to that seen in the 1990s, with a somewhat more subdued increase in financial indebtedness over the same period.

This would see total US indebtedness rise by 9 percentage points (ppt) from the end of 2017 to the end of 2020 to 357% of GDP (*Exhibit 2*). This would remain markedly below the peak level of indebtedness reached during the financial crisis of 382% of GDP. The composition of this debt would be more heavily skewed toward the public sector, 27% of total debt by end-2020, compared with 17% at the start of 2008. The level of household and financial sector debt, as a result is expected to fall to 23% and 26% respectively, from 27% and 33% for comparable time periods. Non-financial business debt is expected to remain stable around 19.5% of total debt.

Exhibit 2

Total US indebtedness (% GDP)

US total outstanding debt



In this final paper of our US debt series, we consider the implications for the US's external deficit. We look at the outlook for the current account balance and its

¹ Page, D., "[The US's dangerous deficit](#)", AXA IM R&IS Insight, 4 May 2018

² Page, D., Venizelos, G. and Ghotgalkar, V., "[Who's afraid of US corporate debt?](#)", AXA IM R&IS Insight, 11 June 2018

relationship with total indebtedness. On most metrics, the US current account deficit looks somewhat elevated and likely to rise over the coming years. We consider the implications that this might have for the US dollar.

Twin deficits: double trouble?

The US current account deficit stood at \$124bn in the first quarter of 2018 or 2.5% of US GDP (*Exhibit 3*). This level is broadly in the middle of the range seen over the past four decades. From the last time the US current account was in surplus, during the recession of the early 1990s, the US current account deficit deteriorated over a period of 16 years to more than 6% of GDP on the eve of the financial crisis as the US economy expanded sharply and domestic savings fell. The financial crisis of 2008 saw a significant turnaround in debt levels. The consumer recession reduced imports, while a decline in the dollar and a significant outflow of portfolio investments all saw the current account deficit fall to nearly a third of its pre-crisis level by the end of 2009. The deficit has remained broadly stable since, helped by the material structural shift in US oil production, reducing the US commodity trade deficit.

Exhibit 3

US historic current account deficit

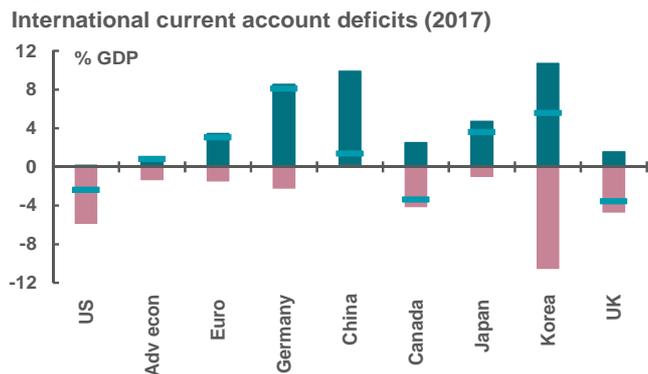
US Current account



The present US deficit is smaller than those of the UK and Canada in percentage terms. Indeed, while the US ran a 6% deficit before the financial crisis, the UK has averaged a deficit in excess of 4% from 2012-17. The US deficit is currently on a par with Australia.

Other advanced economies run current account surpluses, including Japan, Korea and the Euro Area as a whole, which is dominated by the German surplus. China also runs a modest surplus of just under 1.5% of GDP (a far cry from the 10% recorded in 2007). Current account deficits are traditionally associated with emerging economies whose investment needs are greater and which hope to develop the capacity to increase exportable product in the future, thus justifying any current shortfall. South Korea's current account balance for example ranged from a deficit of 10% of GDP in 1980 when the economy was making the transition from emerging market, to a 10% surplus immediately prior to the Asian financial crisis of 1998 (*Exhibit 4*). In 2017, the Korean current account surplus was a still large 5.6% of GDP.

Exhibit 4
Comparable advanced economy current account balances

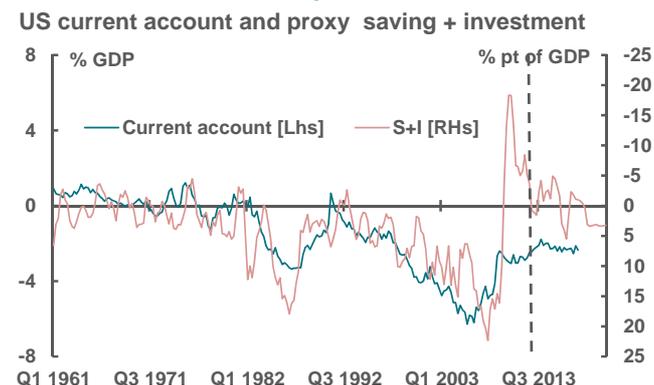


Source: International Monetary Funds (IMF) and AXA IM R&IS calculations

In the US, the current account is primarily made up of the vast trade deficit. In the latest data, the \$124bn current account deficit shortfall for the first quarter comprised a \$221bn goods deficit, offset by a \$65bn services surplus and \$62bn surplus on net investment income from abroad (primary income) and a \$30bn deficit in other transfers (secondary income).

This fuels the US administration’s current concerns over its trade deficits with other countries, particularly China, which accounted for over 40% of the US goods deficit in the first quarter of 2018. However, this focus confuses symptom with cause: the current account shortfall is the product of a domestic macroeconomic imbalance, namely that investment exceeds saving in the US economy. This imbalance creates an excess demand for goods which is satisfied by imports exceeding exports, or conversely capital inflows exceeding outflows. With this view, a reduction in the deficit of one country is only likely to result in replacing one shortfall for deficits in another country³.

Exhibit 5
Current account dictated by macroeconomic imbalance



Source: FRB and AXA IM R&IS calculations

Exhibit 1 provides an illustration of this macroeconomic relationship: assuming US lending to be broadly unconstrained over the period 1970-2008, increased borrowing was synonymous with reduced saving and can

³ To this point, tariffs might prove effective, but only by increasing domestic inflation, reducing real incomes and slowing domestic spending overall i.e. by reducing the underlying imbalance .

be used as a proxy for changes in saving in the whole economy. Exhibit 5 adds the change in investment to our proxy measure of saving, showing variation in this macroeconomic imbalance and the current account deficit.

This simple illustration broke down at the time of the financial crisis, when lending conditions were severely restrained. The change in credit conditions then resulted in a material reduction in ability to borrow, without signalling an underlying increase in saving to the same extent. This was likely exacerbated by debt write-downs (impacting stocks, but not flows).

Similar identification problems have hampered academic attempts to determine the relationship between government deficits and the current account. This is because events of active fiscal adjustment are rare. In a passive environment (where only automatic stabilisers operate), higher GDP growth shrinks the public deficit (reducing spending and increasing tax revenues), but widens the current account deficit (investment increases and saving falls). This suggests an inverse correlation. However, active fiscal policy is likely to see a positive correlation, with fiscal stimulus widening the deficit, boosting growth and widening the current account.

A number of economic studies attempt to disentangle the passive from the active fiscal stance, so as to quantify the specific impact of active fiscal policy. Several⁴ report a similar result of a 1pp rise in the US government deficit resulting in a 0.5 to 0.6pp widening in the current account deficit. Given our expectation of a rise in government deficit (and a broader increase in total indebtedness), our outlook is for a widening in the US current account deficit over the next two years from the current 2.5% of GDP, although we note this magnitude could be reduced by rising US oil production⁵.

When is an external deficit a problem?

External deficits and balance of payments crises have been problematic for advanced and developed economies alike. In the 1960s and 70s, a consistent issue with the current account deficit in a period of capital controls, resulted in the UK’s ‘stop-go’ policies⁶, which ultimately resulted in the need for a loan from the International Monetary Funds (IMF). As capital markets have become more global, balance of payments crises have been increasingly associated with emerging markets.

Beyond a current account position reflecting expectations of future balances, it will also depend on the extent of an economy’s foreign assets/liabilities and the differential

⁴ Bluedorn and Leigh, “Separated at birth? The Twin Budget and Trade Balances”, IMF, Sep 2011; “Understanding the Twin Deficits: New Approaches, New Results”, FRBSF, Jul 2005.

⁵ The magnitude of the current account imbalance will be governed by the relative elasticities of US exports/imports, describing how responsive relative US demand will be to a given change in income. The shift of the highly inelastic and significant oil demand from import to export could have a material impact.

⁶ Strong growth raised the UK’s external deficit and had to be ‘stopped’, slow growth resulted in rising unemployment, resulting in policies to make the economy “go” again.

between its investment returns and its cost of borrowing. These conditions can make current account deficits prevalent in emerging economies (e.g. South Korea in the 1980s), with high expected investment returns resulting in future surpluses. For the US, low borrowing costs encourage the growth of the deficit.

Much of the analysis of current account problems has focused on emerging markets. This suggests that a country tends to be able to run persistent current account deficits if its economy has:

- A flexible exchange rate regime
- Trade openness
- Export diversification
- Coherent fiscal and monetary policies

Studies have found the following can leave economies vulnerable to current account deficits:

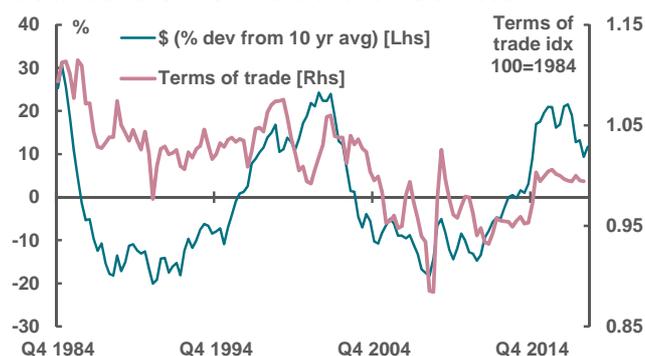
- Overvalued real exchange rates
- Inadequate foreign exchange reserves
- Fast domestic credit growth
- Unfavourable terms of trade shocks
- Low growth in partner countries
- Higher interest rates in industrial countries
- Large foreign currency liabilities
- Capital inflows dominated by volatile portfolio investments
- A weak financial sector

While some of these conditions appear less relevant to a country like the US and some are not relevant at all, there are a few that will likely have a bearing.

Exhibit 6

Dollar and the terms of trade

Dollar deviation from trend and terms of trade



Source: BEA and AXA IM R&IS calculations

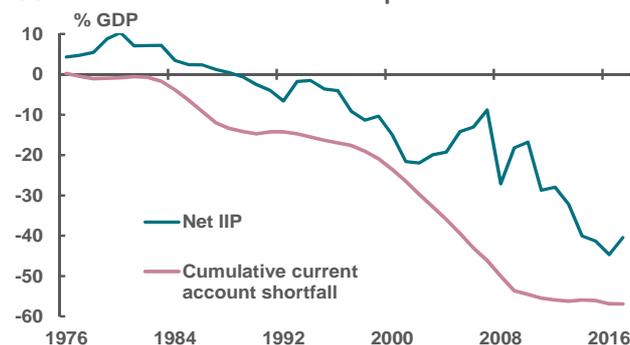
An overvalued real exchange rate. The US dollar has appreciated against a broad basket of currencies since 2014. The best measure is the real, trade-weighted dollar index. With the exception of the first quarter of this year, since the start of 2015, the US dollar has been 12-21% higher than its previous 10-year average (Exhibit 6). US terms of trade have shown a gradual improvement since the dollar lows of 2011. Movements over the past few years do not constitute “a shock”.

Large foreign currency liabilities. The US has amassed a large net international investment position shortfall. In broad terms, this marks a continued shortfall in the current account (requiring ongoing overseas borrowing, or capital inflows). However, since the mid-1970s, net foreign assets have fallen by 40ppts of GDP to 2017 (Exhibit 7), compared with a cumulative current account shortfall of 57ppts over the same period. This difference reflects a number of factors possibly including valuation effects, superior relative returns and the US’s position as the world’s banker. Nevertheless, with expectations for a continued worsening in the current account deficit, the US net foreign currency asset outlook is likely to deteriorate further.

Exhibit 7

US net foreign asset position

US - Net international investment position



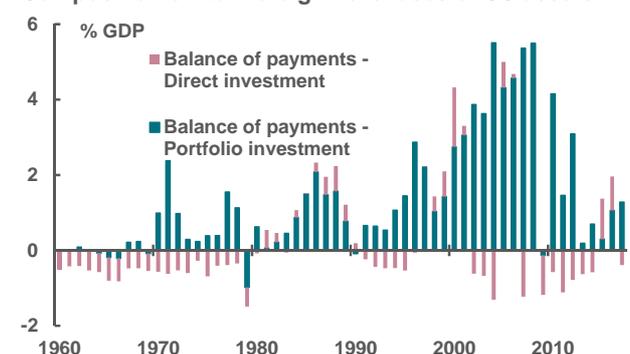
Source: BEA and AXA IM R&IS calculations

Portfolio investments. A current account shortfall has to be funded by capital inflows. If those inflows reverse swiftly, the financing of the current account could be precarious. In terms of capital inflows, direct investment, including foreign direct investment, can be seen as relatively “sticky” investment, whereas portfolio investments, for example investments in capital markets, can be reversed easily. In the run up to the financial crisis (alongside a fast pace of domestic credit growth), the US amassed ever greater debt as its current account deteriorated. This was increasingly financed by portfolio inflows, which rose to 5.5% of GDP in 2008, before collapsing to a modest net outflow the next year. At present, portfolio investment is again the key source of finance for the capital account with direct investment contracting in 2017. However, portfolio investment does not appear excessive by historic standards (Exhibit 8).

Exhibit 8

Composition of the US capital account

Composition of Net Foreign Purchases of US assets

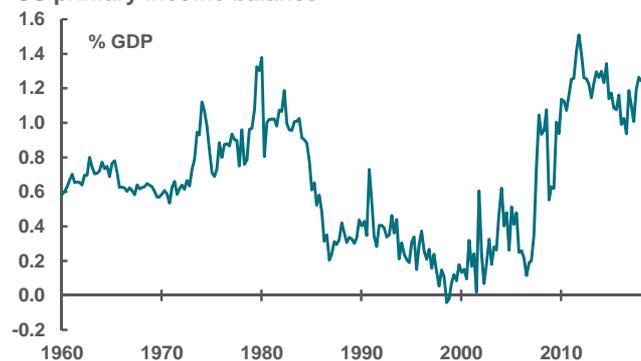


Source: BEA and AXA IM R&IS calculations

We would also suggest there is some concern over the "coherence of fiscal and monetary policy". Monetary policy remains set according to international norms. However, the recent US fiscal stimulus package has elevated the US deficit, which is expected to remain persistent. This is boosting activity at a time when the economy is already around full capacity and increases the difficulty for the US Federal Reserve in managing monetary policy. It could also result in a worsening of international investors' confidence in the outlook for the public finances.

Reserve currency status. However, a key difference between the US economy and others, is the use of the dollar as a global reserve currency. This provides some advantages to the US economy⁷. It provides a source of relatively cheap funding for the US as other international economies have a desire to hold US currency reserves, with less regard to the return paid on them. This is part of the reason that, despite the US's large net international investment deficit, it is able to maintain an income surplus on its net overseas investments (primary income, *Exhibit 9*). This surplus in turn mutes the impact of a large trade deficit on the current account. This is a benefit to the US, but the corollary is that it creates macroeconomic circumstances that nudge the US towards a low saving rate, which in turn contributes to large international trade deficits.

Exhibit 9
US Primary Income balance
US primary income balance



Source: BEA and AXA IM R&IS calculations

This reserve currency status also means that concerns about the US current account are more likely to result in an impact on the currency, than in a full blown balance of payments crisis.

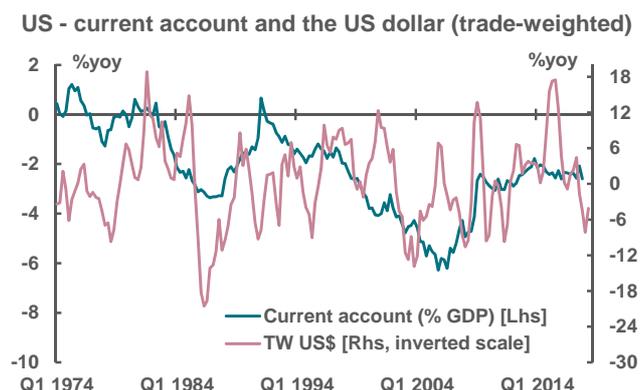
Will a rising external deficit affect the dollar?

The relationship between the US external deficit and the dollar is not striking (*Exhibit 10*). At some points in time, dollar movements have coincided with changes in the current account, including for much of the 1980s with the deterioration in current account deficit and the drop in the dollar seen during the early to mid-1980s and the subsequent current account and dollar improvement that took place toward the end of that decade. A similar path can also be sketched from the late 1990s until the

⁷ Described as an "exorbitant privilege" by the then French Minister of Finance, Valérie Giscard d'Estaing (1965)

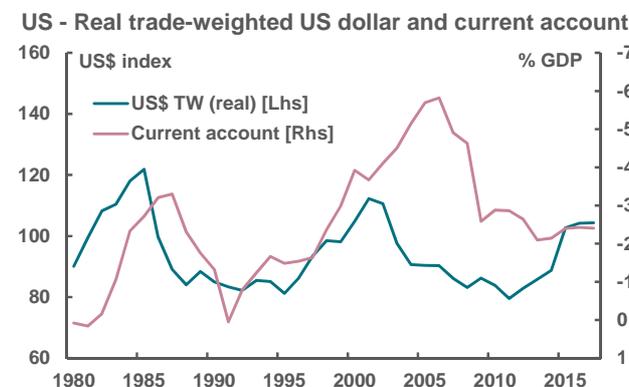
financial crisis with a subsequent broad dollar improvement as the current account improved.

Exhibit 10
Dollar movements and the current account



However, at best any such relationship includes significant dollar volatility. Moreover, periods of persistent current account decline have coincided with little persistent trend in the dollar, as was evident, for example, between 1991 and 2006. Looking at smoother annual aggregates (*Exhibit 11*), the current account appears to react, with a lag, to changes in the dollar (and not the other way around) and appears negatively correlated. Both are more consistent with a depreciating dollar shrinking the current account deficit (as exports become relatively cheaper and imports more expensive), rather than a widening current account deficit weakening the currency.

Exhibit 11
Smoothed current account and US dollar moves



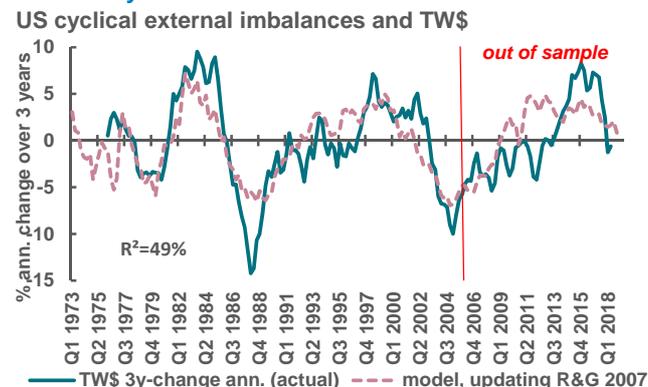
In a 2007 paper⁸, Pierre-Olivier Gourinchas & H el ene Rey showed that such reverse causality also holds in the case of the US: using cyclically-adjusted metrics, their paper concludes that "external imbalances predict net foreign portfolio returns and the exchange rate". Their paper showed that deviations of the current and capital account from longer-moving trends provided a forward-looking guide to the trend outlook for the dollar. Updating this historic paper⁹, we find this method can be shown to explain around 40% of dollar movements over the two to

⁸ Rey H. and Gourinchas P.-O., "[International Financial Adjustment](#)", Journal of Political Economy, August 2007.

⁹ Clavel, L., "[US\\$ appreciation: the force awakens but mildly](#)", AXA IM Research, 7 January 2016

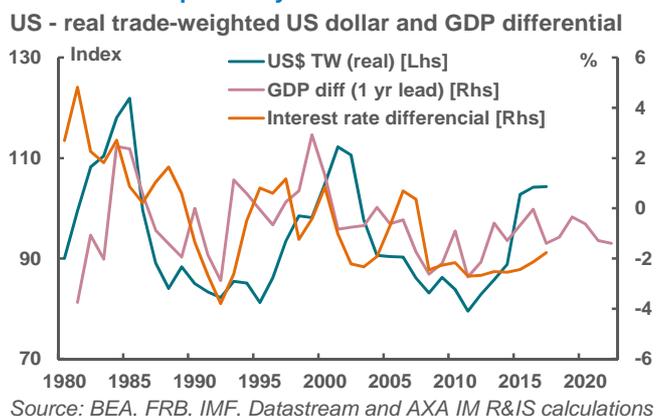
three year horizon. This trend analysis is not useful, however, for capturing short-term movements in the dollar (it explains <10% of next-quarter dollar movements) or volatility (*Exhibit 12*).

Exhibit 12
Rey and Gourinchas model captures long-term dollar trends only



The large amount of dollar movement left unexplained by these trend developments illustrates the role of other factors. *Exhibit 13* shows the trade-weighted dollar with US GDP and interest rate differentials (with trade-weighted international economies). Of these, the GDP growth differential explains just over half of the movement in the dollar and is statistically significant over the time horizon. It outperforms the interest rate differential in both measures. Also note that changes in the size of the US government deficit (relative to other governments) have appeared to coincide with movements in the dollar, particularly since the mid-1990s.

Exhibit 13
Other dollar explanatory variables



This broad range of possible explanatory variables may explain some of the conflicting outlooks for the dollar at present. However, using the longer-term trend determinants of the dollar and our forecasts for key variables ahead, we come to a consistent outlook. Whether we consider cyclical deviations in the current account, GDP or interest rate differentials, differences in the public finances outlook or the likely path of the net international investment position, all suggest that short-

term dollar strength should give way to dollar depreciation over the coming years.

Conclusions

Closing our review of US indebtedness, we conclude that the projected government deficit outlook is elevated and could rise further in the event of economic deceleration, which we consider more likely than not over the time frame. For now, a short-term reappraisal of US sovereign risk appears unlikely as the economy expands solidly. Yet economic downturn might result in increased financial market caution that could lift US Treasury yields, restricting the government’s fiscal room for manoeuvre. We suggest that ultimately, the US is likely to have to follow a tighter fiscal path than presently projected by the Congressional Budget Office.

In considering the outlook for US corporate debt, we recognised that as a percentage of GDP, non-financial corporate debt was currently as high as before the two previous downturns. However, the growing share of corporate earnings and profits as a share of GDP means that corporate debt appears less elevated as a proportion of business income. In a more detailed assessment of the corporate debt market we further noted that while we could identify pockets of vulnerability, this was far from systemic. Rising interest rates and tax reforms should also lower corporate leverage over the coming years.

We expect total US indebtedness to rise over the coming years, with additional modest increases in household and financial leverage as regulations on community banks are gradually loosened, easing some of the headwinds to mortgage lending. We see US indebtedness rising back to 357% of GDP by the end of 2020, up 9ppt from the current level, but still 25ppt below the financial crisis highs. However, we note a shifting composition of this debt, more towards public indebtedness.

This leads us to conclude that there is no malign build-up of financial imbalances, as we saw before the financial crisis, whose unwind might precipitate the next downturn. We are particularly reassured by reduced financial debt, larger banking sector capital buffers and a more sanguine assessment of non-financial corporate debt.

However, indebtedness does increase the US economy’s fragility. While not expecting these imbalances to spark the next downturn, they could easily exacerbate one that materialises for other reasons. Our concern is that US economic growth could slow markedly from 2020 onwards as fiscal stimulus fades in the face of decelerating real income growth and tightening financial conditions - perhaps earlier if the escalation of trade wars goes further than we think. Once the economy begins to weaken, the worsening public deficit could increase concerns about the US fiscal outlook. Weaker growth could also result in a dollar weakening, particularly in the context of a growing external imbalance that could exacerbate real income declines.

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