MAI VIEW

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Trump, the Bag Holder

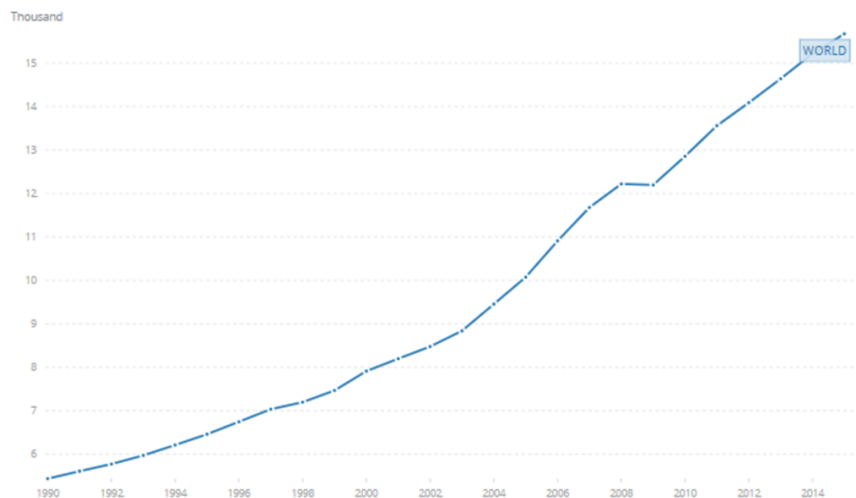
We should discover quickly the limited efficacy of Donald Trump's economic initiatives.

President Trump's primary economic goal is to increase US GDP to four percent from less than two percent in 2016. The most expedient way to raise output has traditionally been to raise demand through accommodative Fed policies; lowering interest rates to expand credit. As demonstrated by the last years of the Fed's zero interest rate policy (ZIRP) that ran from 2008 to 2015; however, while there is no limit to credit creation at the zero bound, there is a limit to the productive use of credit. (Think stock buy-backs and new debt to service old debt.) *GDP began to stagnate because increasing credit did not produce a commensurate increase in production (or, Mr. Trump's other goal, more and better American jobs)*.

Unlike the smooth nature of monetary policies (smooth yet insidious when one considers its detritus - unsustainable debt loads), the new emphasis on fiscally-driven economic policy was inevitable. It is bound to be messier than easy monetary policies. The consequences of a regime that uses active currency, tax and immigration policies to raise domestic production, labor and foreign trade are more immediate and potentially harmful to other economies. In terms of the global economy, BIS-coordinated credit policies enlarge the global pie, at least temporarily, whereas domestic fiscal policies are zero-sum and hostile.

In a world with a flexible exchange rate monetary system it is tricky to get a handle on the health of the global economy by measuring global GDP. It must be calculated in Purchasing Power Parity (PPP) terms; basically, pro rata output from all economies is converted into US dollars (i.e., "international dollars") and divided by the total population. Graph 1 shows the very linear (and unnatural) trend of global GDP using this method.

Graph 1: World GDP per capita, PPP (Current International $)



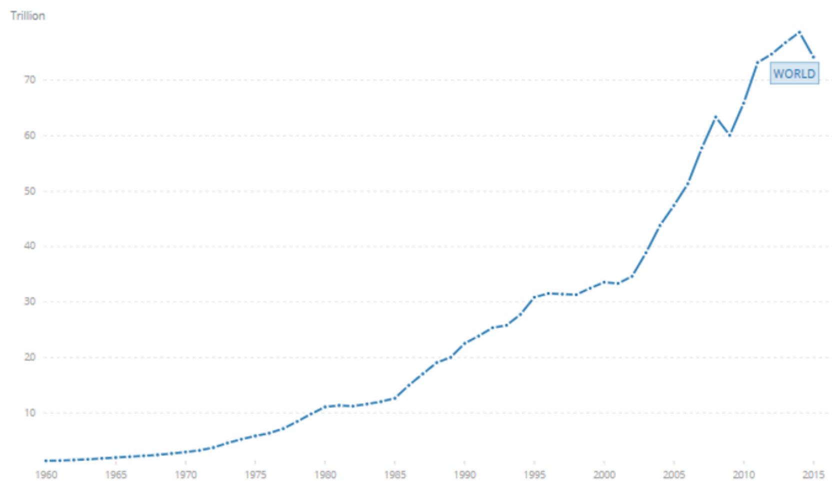
Sources: World Bank; World Bank and OECD National Accounts Data.

To maintain consistent trend growth for the latest year on the graph (2015), the dollar had to strengthen by 11%, which served to offset a 60% decline in crude oil prices that began in 2014. The net effect of this significant dollar strength was more purchasing power for dollar holders and less for everyone else, including producers and manufacturers in other economies.

We can better understand the health and dynamics of the world economy when we twist global GDP around. In current US dollars it fell over 6 percent in 2015 to $74.2 trillion from $78.6 trillion in 2014. That was actually a steeper drop than during the onset of the financial crisis in 2008/2009, when it fell about 5 percent. (The IMF estimates world growth in 2016 will be 3.1 percent and optimistically anticipates 3.4 percent in 2017.)

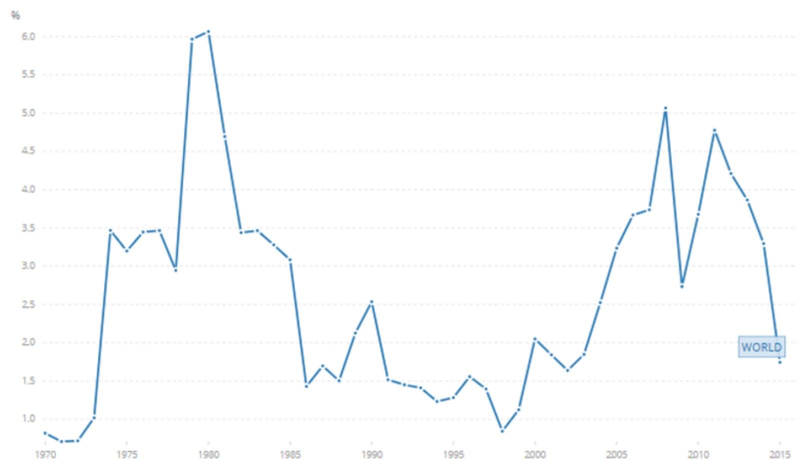
Comparing global output in PPP versus current dollars terms in 2015 should raise some eyebrows. Stable global growth in current dollars relies on a stable dollar and stable oil prices. Whether or not it was the result of changing production (e.g. US shale), geopolitics (e.g. punishing Russia for annexing Crimea), or both, market forces produce winners and losers that the dollar must then adjust to so that the global economy appears stable.

Graph 2: Global GDP (Current US dollars)



Sources: World Bank; World Bank and OECD National Accounts Data.

Graph 3: Total Natural Resources Rents (% of GDP)



Sources: World Bank; World Bank and OECD National Accounts Data.

When we take a step back and think about the many different inputs that determine how much global output grows or contracts in any given year – including the opening of large, formerly closed economies like China and Russia in the 1990s – it strains credulity to accept the linearity of global economic output growth in PPP terms as a telling indicator. More importantly, it shows the critical nature of the US dollar in global trade. *A unilateral American dollar policy, perpetuated by Treasury secretaries from John "it may be our currency but it's your problem" Connally to Bob "strong dollar policy" Rubin to Silent Jack Lew, have been a fundamental pillar of broader US foreign policy doctrine since the end of Bretton Woods. Active dollar management maintains its hegemonic status around the world, which provides the US with control over trade and great influence over geopolitics.*

Enter Donald Trump and his new Secretary of State, Rex Tillerson. Some may have thought it strange that an oil man was placed in charge of US foreign policy. We think it was both refreshingly honest and worrisome. Tillerson's appointment sends a signal to the world that the US wants global energy to continue to be priced in dollars and that the US will continue to oversee and protect global shipping lanes.

We highly recommend watching Grant Williams' video presentation, *Get it Got it Good*, which beautifully describes the petro-dollar system managed by the US since the demise of Bretton Woods and signals why it may be cracking presently. The US dollar does not seem to be in jeopardy of losing its status as the world's premier fiat reserve currency (yet) thanks to the relative stability of American government and the vastness of its capital markets and military. However, a very large and growing portion of non-dollar global trade is gaining steam. Williams' presentation brilliantly shows recent actions and reactions taken by China, Russia, Saudi Arabia, Iran and others suggesting the pace of bilateralism is picking up pace.

A trend we and others have discussed over the years is the gradual shift towards a more competitive environment in which the US can no longer call all the shots. Tillerson's appointment stakes out the West's current position in no uncertain terms. It is a position that had to be taken by the sovereign hegemon to foster stability. Energy plays a central role in maintaining domestic tranquility in all economies across the world. Sufficient access to it is good, an abundance of it is better, a lack of it brings the house down.

A New World

The world economy is changing and there is little Mr. Trump, the G7, NATO and the West can do about it, at least in conventional terms. Labor and production are shifting for reasons having nothing to do with economic and financial infrastructures, know-how, technological expertise or cultures of industriousness. They are shifting due principally to the distortion of the global wage scale and its impact on the economic value of production and where it occurs. (More on this later.)

The rate of change towards free-market capitalism is skewed towards economies like China, India, Brazil, Indonesia, Russia, Mexico, Turkey and Iran, and the rate of change towards socialistic entitlement stabilization is skewed towards established advanced economies of the past. *Western and Japanese influence over global commerce and trade will continue to shift and will have to be shared*.

Table 1 on the following page may be an eye opener for investors overseeing the majority of global capital and politicians overseeing government spending. It shows the expected secular shift in the largest economies comprising 84% of global GDP, according to PwC. We may quibble about such shifts by 2030 and 2050, but the general trend seems locked and loaded. China, India and other emerging economies are using their substantial populations and cheap labor to take global market share. Their politicians are also bound to use FX markets to counter US efforts to manage the dollar. There is very little mature, advanced economies can do from fiscal, trade or regulatory perspectives to reverse this trend.

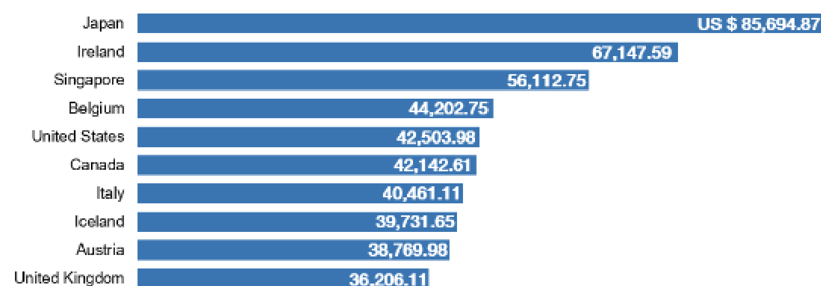
Table 1: PwC - GDP in PPP – 2016, 2030, 2050

GDP PPP rankings	2016 rankings		2030 rankings		2050 rankings	
	Country	GDP at PPP	Country	Projected GDP at PPP	Country	Projected GDP at PPP
1	China	21269	China	38008	China	58499
2	United States	18562	United States	23475	India	44128
3	India	8721	India	19511	United States	34102
4	Japan	4932	Japan	5606	Indonesia	10502
5	Germany	3979	Indonesia	5424	Brazil	7540
6	Russia	3745	Russia	4736	Russia	7131
7	Brazil	3135	Germany	4707	Mexico	6863
8	Indonesia	3028	Brazil	4439	Japan	6779
9	United Kingdom	2788	Mexico	3661	Germany	6138
10	France	2737	United Kingdom	3638	United Kingdom	5369
11	Mexico	2307	France	3377	Turkey	5184
12	Italy	2221	Turkey	2996	France	4705
13	South Korea	1929	Saudi Arabia	2755	Saudi Arabia	4694
14	Turkey	1906	South Korea	2651	Nigeria	4348
15	Saudi Arabia	1731	Italy	2541	Egypt	4333

Source: PwC; http://www.pwc.com/gx/en/world-2050/assets/pwc-the-world-in-2050-full-report-feb-2017.pdf.

Easier access to credit in mature economies has created a massive distortion in global consumption demand and wages, which in turn have distorted the economic value of production across economies. Overwhelming balance sheet leverage and the inability to transfer or extinguish debt through market forces suggest no real or imagined Trump initiatives will be sufficient to reverse these distortions.

The graphic below is a representation of public debt-to-GDP in terms of how much each man, woman and child would have to contribute to pay off their nation's *sovereign debt*. We should keep in mind that the figures do not include unfunded entitlement liabilities promised by governments, or the debt each household and corporate has assumed on their own.

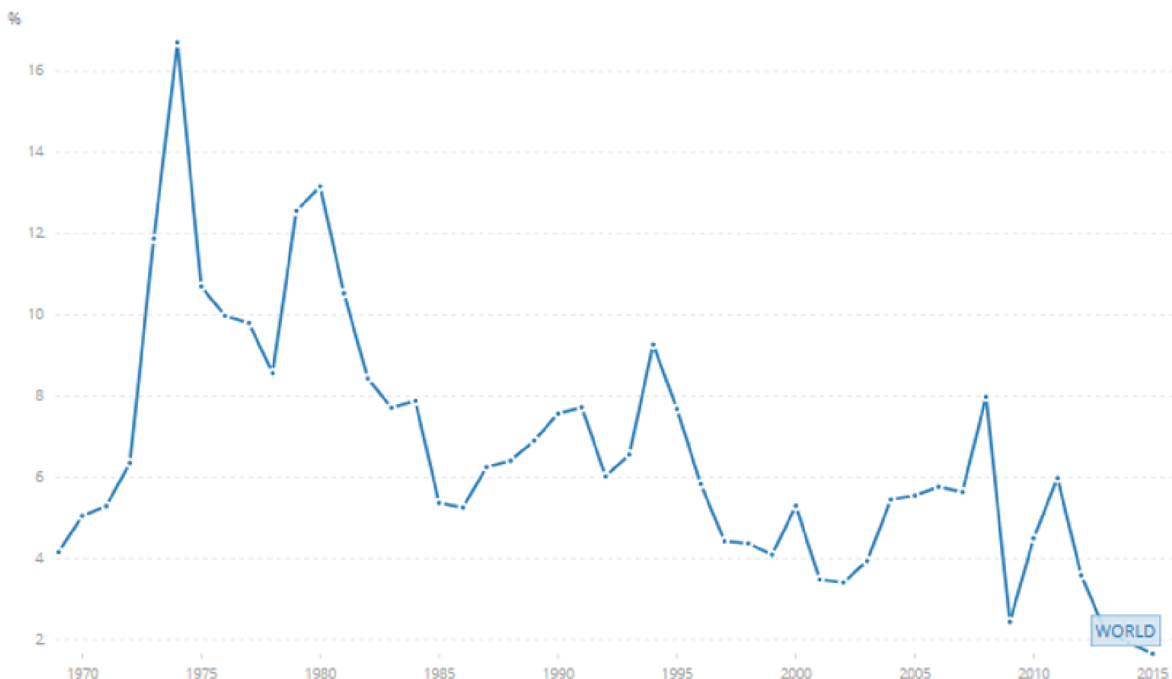


Economies modeled on un-extinguishable credit based demand are societies that do not build sustainable wealth. The factors of production, as they were classically called, become the factors of finance. Wages and goods and service prices must rise to service debt. The need for higher wages in indebted economies keeps the door open for cheaper production elsewhere. Thus, the economic incentives driving global commerce and trade continue to be geared towards labor and production in lower-cost economies.

It is too late to equalize this troubling economic reality through political and fiscal maneuvering. Arm twisting of corporations by the Trump administration to keep production in the US cannot reverse incentives on a scale that would make a material difference, nor would a hefty border tax on imports or erecting a wall that keeps out lower-cost labor work to the benefit of Americans. While immigration and protectionism may increase the demand for American labor, they would also raise the prices of goods and services to American consumers. And while government-sponsored infrastructure spending may improve roads, bridges, airports, tunnels, the electric grid, etc., it also would sharply raise the bill Americans must ultimately pay.

In the end, domestic fiscal policies and antagonistic trade policies will be unable to move the output needle in the US and around the world. The new emphasis on Keynesian initiatives in the US should accelerate, not retard, painful economic reconciliation of the global wage scale. It must settle lower in real terms. We expect global production, trade volume and real prices to continue to fall naturally, all else equal.

Graph 4: Global Inflation, GDP deflator (annual %)



Sources: World Bank; World Bank and OECD National Accounts Data.

All else is not equal. Businesses and the political dimensions in advanced, highly indebted economies are unlikely to continue very long on a course that does not work. As we have argued, we anticipate an agreement that reduces *the burden* of debt repayment, rather than debt repayment itself, through central bank-administered hyperinflation. This is vastly more politically expedient than living through debt deflation, widespread defaults, nominal economic contraction, mass layoffs and bank system insolvency.

Before coordinated currency devaluations occur, we expect the global political dimension, led by Donald Trump, to pursue and exhaust hyper-Keynesian measures. It should become apparent to the markets immediately that they will not be economically stimulative in real terms. The sooner Mr. Trump embarks on these policies, the sooner the markets will begin to discount hyperinflation. We expect it to come to a head during the Trump administration.

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