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The trade deficit – a free lunch?

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Summary: a country can run a trade deficit indefinitely

It is perfectly possible to run a current account deficit indefinitely – a country just has to be better than the rest of the world at trading assets. If foreigners always buy American assets at the top of the market – better still assets which never pay a dividend or subsequently go bust (like internet stocks or junk bonds) – and Americans buy highly profitable assets abroad which always appreciate in value, America can run a permanent current account deficit and have constant (even declining) net liabilities to foreigners. Analysis of the US balance of payments suggests that this description may not be that far off the mark.

Changes in the relative value of overseas assets and liabilities to foreigners are key

Despite being the single most important factor in the net foreign liabilities of the US, changes in the value of American assets overseas relative to foreign-owned assets in the US are nearly always ignored in the debate on the trade deficit. One reason for this is the absence of reliable data and the difficulty of estimating values for many assets. The Commerce Department's quarterly balance of payments data does not report changes in the relative value of US foreign assets and liabilities, it simply shows the gross and net capital inflows and outflows broken down by type. Cumulative gross capital flows are often used as a very crude proxy for the size of the stock of external liabilities. The main problem is that these flows are valued at purchase price and no account is taken of capital gains/losses or profitability.

Americans make more money abroad than foreigners make in the US

The Commerce Department's Bureau of Economic Analysis does attempt to provide annual data on the value of US net liabilities to foreigners. On our estimates, both its measures – current cost and market value – misrepresent changes in the net stock of US external assets/liabilities. Our analysis of US balance of payments and flow of funds data shows that changes in the relative values of the stock of net FDI has had beneficial impact on the stock of external assets, offsetting the impact of the annual current account balance. Furthermore, we conclude that **Americans appear to have traded in securities, as well as FDI, far more profitably than foreigners, and the expanding US current account deficit has had minimal impact on the stock of US net external liabilities – this is as close as it gets to a free lunch.**

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Valuing net external liabilities

Discounted cashflow

The current account data for the US breaks down the income received on US assets abroad into income accruing to foreign direct investment and income accruing to other private assets (mainly loans and securities). We can attempt to derive a present value for FDI by doing a simple discounted cashflow on this income flow. The payout ratio, discount and growth rates to use is complicated by the absence of data on the riskiness of FDI assets. But our basic purpose is to gauge roughly how the value of these assets has changed relative to the accumulation of external liabilities – and whether this has exacerbated or offset the accumulation of external liabilities implied by the current account deficit.

The value of US net FDI has risen by \$220bn since 1996

We have assumed a dividend payout ratio of 30%, a risk free rate of 6%, a risk premium of 3%, and a 6% growth rate. This suggests a current value of US FDI of \$1.6trn. Using the same discount rate, the stock of foreign FDI in the US is valued at \$670bn. What is remarkable is how this has changed in the last four years during the huge widening of the US current account deficit. At the end of 1996 we estimate the present value of US overseas FDI at \$1trn, and accumulated FDI in the US at \$330bn. Since then, the value of US FDI has risen by almost \$560bn, and foreign FDI by \$360bn – despite a surge in additional FDI into the US. Foreigners have been paying more for assets in the US but Americans have been creating far more value (see Fig 1). **America is running a current account deficit but is not accumulating liabilities because it is investing in more profitable assets than it is selling.**

US income overseas grows faster than foreign assets in the US

A potential flaw in our approach is that the discount rate for US FDI overseas should be higher than the discount rate for investment into the US. Particularly given US investment in developing economies (although American investment in Europe and Japan constitutes the vast majority of direct investment abroad – and the cost of capital is lower). It is highly likely, however, that a higher risk premium would be more than offset by faster income growth. However, the evidence suggests that US FDI income has consistently generated faster growth than income accruing to FDI into the US. The cumulative inflow of FDI into the US (valued at purchase price) in the last 5 years has been \$960bn and income payments to FDI have risen by \$35bn or 3.6% of the cumulative inflow. US outflows of FDI totaled \$647bn and FDI income received rose by \$47bn or 7.3% of the cumulative inflow – suggesting that US overseas assets are more profitable.

Measured by the volatility of earnings, US assets overseas are less risky

Furthermore it appears that US investment overseas is less risky. One way to proxy the riskiness of an asset is through analysis of the volatility of earnings. Using the data available since 1964, income paid by the US on direct investment by foreigners has been far more volatile than income received on FDI. The standard deviation of the growth rate is 0.14 for US FDI and 0.75 for direct investment into the US. So not only are American assets abroad earning far more than foreign assets in the US, but they are arguably less risky.

Fig 1 Change in net FDI 1996–2000, \$bn

FDI only (\$bn)	BEA estimate (mv)	BEA estimate (cc)	Cazenove estimate
Assets 1996	1526	987	1025
Assets 2000	2468	1508	1583
Liabilities 1996	-1229	-743	-330
Liabilities 2000	-2736	-1472	-667
Change in net assets	-565	-208	221
Net cumulative inflow of FDI (1997–2000) on balance of payments	-450	-450	-450

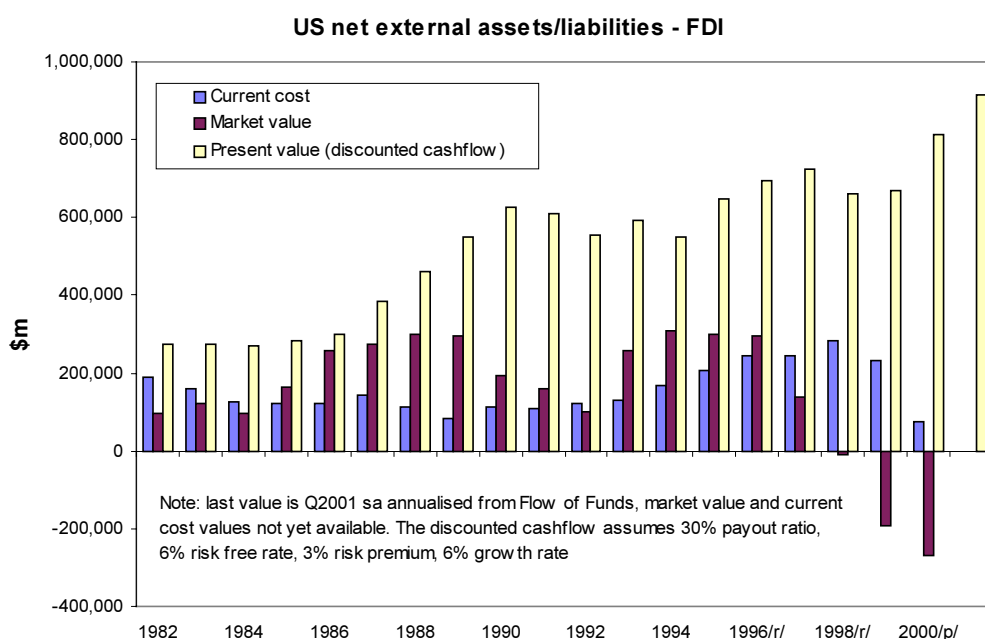
Note: Cazenove valuation is for Q101, BEA data is end 2000. The BEA two valuation approaches are market value (mv) and current cost (cc), Cazenove is discounted cashflow.

The Fed and BEA analysis of the balance of payments confirms the superior profit performance of US FDI. Indeed both the Fed and the BEA have done considerable research into why US FDI is much more profitable than foreign direct investment into the US.

Market value and current cost measures take no account of differentials in profitability

However, their estimates of the value of net FDI have not changed nearly as much. The BEA uses changes in destination market equity indices, not earnings, to value net FDI. Our methodology seems considerably sounder. In dollar terms, the Mexican stock market has barely appreciated in value since 1992. It is highly implausible that there has been no appreciation in the value of directly owned US assets in Mexico – particularly when the majority will have dollar revenues and peso costs, in contrast to most of the listed equities. Local equity markets are not at all indicative of returns by multinationals in those economies – SE Asia, where a high proportion of US overseas IT capacity is located – would be another striking example. Furthermore, these equity markets are correctly valued with very high risk premia because their earnings are so volatile. Our analysis suggests that the volatility of profits accruing to US overseas direct investment is actually quite low.

Fig 2 Net FDI – current cost, market value and present value



Source: BEA, Federal Reserve Board, Cazenove

Current cost and market value approaches are not sensitive to profit differentials

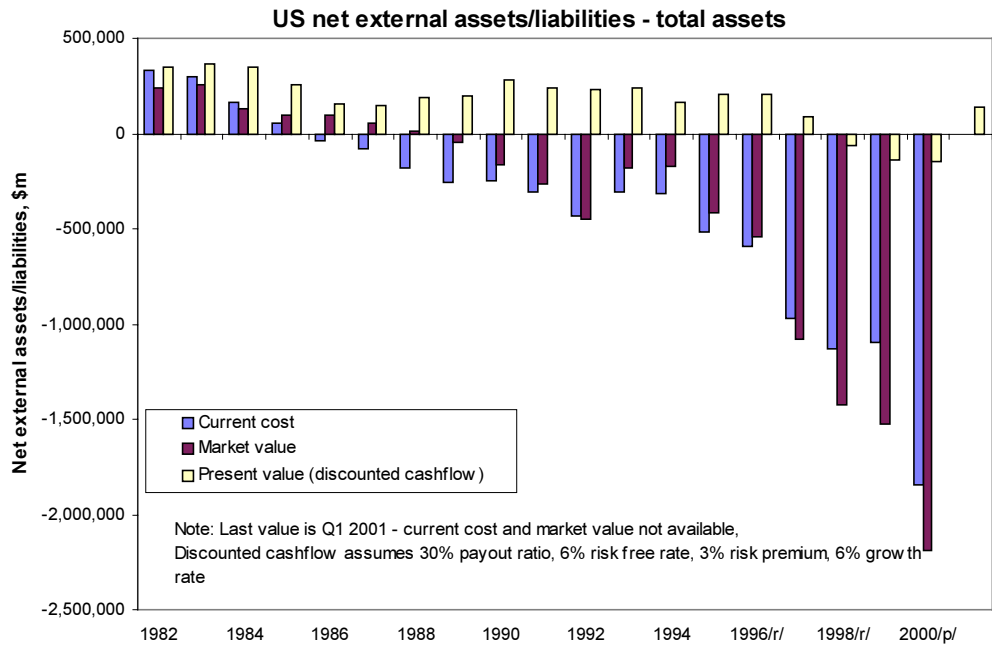
It is no surprise that on the BEA estimates the relative value of US net FDI has declined – the US stock market has outperformed the rest of the world in US dollars. But this tells us little about the value of FDI – the US stock market cannot be a good proxy for the value of FDI into the US, which has lower profitability than corporate America.

The current cost approach is also very limited. The current cost valuation method is very similar to replacement cost valuation techniques in equity markets and tries to proxy changes in the values of tangible assets using land price indices, market price of inventory and replacement cost of plant and machinery. Again the biggest flaw in this approach is the failure to take into account profitability. It also ignores intangible capital.

What about other assets?

So far our analysis has only concentrated on FDI. What it shows is that the relative profitability of capital flows is probably a more important determinant of the net external liabilities of the US than the current account. Furthermore, American-owned capital appears far more profitable than foreign owned capital inside and outside the US.

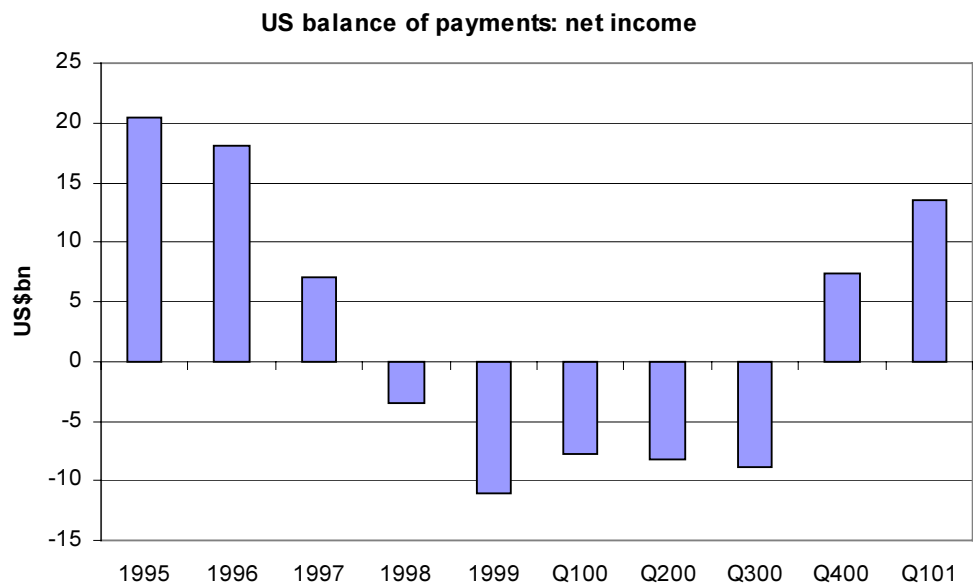
Fig 3 Net external assets/liabilities: current cost, market value and present value



In the aggregate, the US has accumulated net external assets in the aggregate

It is possible that changes in the value of securities – which is the other main asset/liability – have either compounded or offset this effect. If we valued the changes in net liabilities on the same basis as above – a discounted cashflow derived from the net income flow using the same discount rate – the US still appears to have accumulated net assets, see Fig 3. Confirming the higher income earned on overseas assets, net income on the current account has actually turned positive in the last two quarters (see Fig 4).

Fig 4 Income received on overseas asset less income paid



Source: Federal Reserve Flow of Funds Q2 2001

Why do Americans own more profitable assets?

Lower cost of capital

Economic purists would argue that there should be a structural bias in the trade of assets in favour of current account deficit countries, on the basis that domestic investors have more information about domestic assets and deficit countries are selling more assets to foreigners than they are acquiring abroad. There may be other structural reasons for Americans trading more successfully abroad than foreigners trading in the US. Differentials in cost of capital and hurdle rates for direct investment almost certainly bias American overseas investment towards more profitable assets.

Over-paying for acquisitions

Anecdotally, it is well known that American firms find it extremely difficult to find existing businesses in Europe and Japan which have sufficient return on equity to merit acquisition. Most US overseas investment is in the production of own-brand goods and services. Shifting US manufacturing capacity to the developing world – which shows up as FDI capital outflow – is hugely profitable. In contrast, the European track record on FDI over the last 5 years is a rather sorry tale of over-priced US acquisitions. Selling low yielding treasuries and stocks and investing in highly profitable manufacturing capacity in the developing world is certainly one way to finance a structural current account deficit.

BEA and Fed research has tended to concentrate on why FDI into the US seems to earn less than US owned domestic businesses, which is equally intriguing (See *An Examination of the Low Rates of Return of Foreign-Owned US Companies*, Survey of Current Business, March 200 by Raymond Mataloni). In addition to cost of capital effects, most of the research cites start-up costs, the low return on assets prior to acquisition, and expensive acquisitions. Broadly, research finds that profit-shifting using transfer pricing (for tax purposes) is unlikely to be a major factor.

Income on other assets also appears to be higher

Income on assets other than FDI (mainly securities) also appears to be higher for US overseas holdings than for foreign holdings of US assets. The composition of assets owned is probably a factor. Due to the reserve currency status of the dollar we know that official purchases of US treasuries are a disproportionate share of US external liabilities.

Finally, foreign direct investment constitutes a far greater share of US capital outflow than inflow, and has a higher yield than US securities.

Conclusion

It is increasingly clear that current account balances are of little relevance to currency behaviour, at least in the developed world. What matters is the relative attractiveness of assets. If assets in Europe and Japan become more attractive than the US – which we don't see anytime soon – the dollar will fall. Not because foreigners will refuse to finance the trade deficit, but because American capital, which seems to be the smartest, will be leaving. As long as US assets are perceived to be most attractive the dollar will hold.

The traditional thesis on the sustainability of current account deficits takes no account of changes in the relative value of external assets and foreign-owned domestic assets or differences in their profitability. These are two factors that are likely to have a more material impact on the stock of external liabilities than changes in current account balances. In the case of the US, it appears that Americans may well have fully offset the impact on their net external liabilities of the large expansion in their current account deficit in the last four years through faster appreciation in the value of overseas FDI.

So don't be a bear on the dollar on the basis of the trade deficit – it's virtually irrelevant.

Appendix

Alternative valuation approaches

Peter Wann, our US economist, has suggested using the market P/E multiples to proxy the value of external assets and liabilities. This has advantages over the market value approach, because the value of assets is adjusted for differentials in profits growth. It also has a number of advantages over the discounted cashflow method, because there are fewer assumptions (risk premium, growth rate etc.) which greatly alter the value.

Because it is sensitive to differences in profitability, the P/E multiple approach confirms the general results of the discounted cashflow. Below is a table of the results. We have used the current P/E multiple for the FT/SP world equity markets ex-US of 20x to value US assets overseas, and the current FT/SP US equity market multiple of 24x to value foreign FDI in the US. On this basis the US has accumulated net FDI assets of \$141bn since 1996.

Fig 1 Value of net FDI

FDI (\$bn)	BEA market value	BEA current cost	PV	Market value (P/E-based)
Assets end-1996	1526	987	1025	2363
Assets 2000	2468	1508	1583	3144
Liabilities end-1996	-1229	-743	-330	1092
Liabilities 2000	-2736	-1472	-667	1732
Change in net assets	-565	-208	221	141
Cumulative current ac deficit (1997-2000)	-450	-450	-450	-450

Source: Cazenove, BEA, Rimes

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