# Musha Research

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# The true nature of the Trump administration and a stronger dollar

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The dollar's current strength is a surprise for many market participants. In many strategy reports (Strategy Bulletin vol.173 (Dec 14, 2016) "2017 will be shaped by a strong US economy, strong president and strong dollar", vol.175 (Jan 12, 2017) "A strong dollar is the behind-the-scenes star of Trump politics", vol.177 (Feb 3, 2017) " The true nature of the Trump administration – Imperialism, not protectionism ~An offensive rather than defensive stance~", vol.195 (Mar 5, 2018) "Great Scepticism about the Strong Yen Theory, etc.), Musha Research has said repeatedly that a prolonged period of a strong dollar is about to begin. Its possibility is increasing.

## (1) Reasons for a weaker dollar have been entirely discredited

The dollar's strength is completely undermining the long-standing beliefs of dollar pessimists.

1) Now that the United States is in its 10th year of consecutive economic growth, the longest in the postwar period, a recession will soon begin.
2) Low inflation and interest rates and the emergence of an asset price bubble will simultaneously widen the US income gap and slow economic growth, a sign of the impending decline of US-style capitalism.
3) The long-term cycle of seven years of dollar appreciation followed by 10 years of depreciation entered a depreciation phase in 2017.
4) A trade war and higher tariffs will cause the dollar to become weaker.
5) President Trump's trade protectionism is certain to erode the dollar's strength.

There is now no doubt that these and other beliefs of dollar pessimists were wrong.

There are no signs that a recession is about to begin in the United States. Almost all economists, the Fed and many others agree that the US economy will continue to expand until at least 2020. At this point, there is no need to explain once again that the United States has the world's most energetic economy because it is at the center of the industrial revolution driven by the internet, artificial intelligence and other technologies.

In Strategy Bulletin No. 195, Musha Research made the following statement about the problem of using the long-term cycle of dollar strength and weakness as the basis for expecting the dollar to depreciate.

The greatest reason for the strong yen theory is that the wave of long-term dollar circulation has already entered the dollar depreciation phase. Looking back on the dollar cycle marked out over more than 40 years, the dollar has been strong for seven years, then weak for ten years. If this pattern is applied, then the dollar strength that began in 2011 simply cyclically shifted to dollar weakness in 2017. However, the main factor that dominated the long-term cycle of the dollar was the economic conditions and the policy priorities in the US. The firmness in the US domestic economy due to the priority placed on suppressing inflation, issuing warnings of a bubble, and the promotion of global investment, all correspondingly led to monetary tightening and drove the dollar higher (1978-1985, 1995-2001, and after 2011). Conversely, when the domestic economy was in a slump, priority was placed on economic leverage, deflation avoidance, the strengthening of export competitiveness, with monetary easing and measures to oppose dollar appreciation being implemented (1973-1978, 1985-1995, 2001-2011). So, what is the current economic situation in the US and what are its policy priorities? It is clear that the US economy is now in a solid phase, that the risk of inflation is higher than that of deflation, and an ever-stronger emphasis is increasingly being placed on asset bubble warnings. In other words, this means that the strong dollar makes sense. The starting point of the dollar's rise this time may also be important. Between 2011 and 2014, the dollar's appreciation was merely equivalent to the dollar creeping along the bottom, and the dollar was stagnant at its historic low-price level during the period of the US's super monetary easing (QE). The rise in the dollar started in earnest in the latter half of 2014 when QE3 was over and the Fed's balance sheet expansion had ceased. It's fair to say that it has still only been over three years since the beginning of the de facto appreciation in the dollar, and so the theory that holds that we have already entered the long-term dollar depreciation phase cannot be said to be convincing.

In analyzing the economic fundamentals, almost everything is a high dollar factor. 1) The tightening of monetary policy and adoption of a fiscal expansion policy are both classically typical high currency factors, 2) In terms of interest rate and business confidence among developed countries, the US is the strongest, and so this is consistent with the dollar increase, 3) The strengthening of the global profitability of US companies tends to improve the current account balance, and 4) The nation that is most prone to monetary tightening among industrialized countries is the United States, etc. (Strategy Bulletin No. 195)

## (2) Trade protectionism and higher tariffs will make the dollar stronger, not weaker

The only remaining reason for people to expect a weaker dollar is the belief that the Trump administration's trade protectionism will erode the dollar's strength. But this is probably the biggest fallacy of all and must be corrected.

Based on economic principles, the correct view is instead that a country's currency becomes stronger when it enacts protectionist policies, assuming there are no restrictions on foreign exchange markets. During the Great Depression of the 1930s, many countries devalued their currencies in an attempt to reduce their own economic problems by worsening the problems of other countries (beggar thy neighbor). During US-Japan trade friction, the yen appreciated chiefly because of US pressure. This is why many people equate US trade friction with measures to make the dollar weaker. However, this view is illogical from the standpoint of economics.

When the idea of a border tax emerged last year, Harvard Professor Martin Feldstein wrote a Wall Street Journal op-ed in which he stated that a border tax would not lower the US trade deficit. "A country's trade deficit depends only on the difference between total investment in the country and the saving. Since a border tax adjustment wouldn't change U.S. national saving or investment, it cannot change the size of the trade deficit. To preserve that original trade balance, the exchange rate of the dollar must adjust to bring the prices of U.S. imports and exports back to the values that would prevail without the border tax adjustment that means that the value of the dollar must rise." (January 9, 2017)

The same argument applies to the hike in tariffs on imports from China. Basically, the benefits of trade restrictions and higher tariffs are offset by a decline in the currencies of trading partners. Ultimately, there is no change at all in each country's competitive position. This is the orthodox economic view. In fact, since the renegotiation of NAFTA became bogged down, the Mexican peso and Canadian dollar have depreciated significantly. Weaker currencies have made factories in these countries even more competitive.

## (3) A strong dollar is in the best interests of the United States

Treasury Secretary Mnuchin surprised the market by saying at the Davos Conference that the weakening in the dollar was desirable. As a result, the United States raced into protectionism as if it were taking the lead in a competitive currency devaluation. But is it so? The United States now imports 80 to 90% of its necessary supplies of materials. There is almost no supply capacity in the US for most of these goods. In other words, the United States is engaged in very little if any price competition with other countries. Therefore, it cannot be that currency devaluation will improve the trade balance. In the Reagan era in the 1980s, the United States produced about 60% of its necessary supplies of materials domestically, and so the role of the dollar depreciation policy in supporting domestic producers had some significance, but now the circumstances are completely different. (Although it is only trying to weakness in its currency against China (= curbing downward devaluation in the RMB), it is still the case that maintaining a strong RMB is the key in the trade friction between China and the US).

So, is not the reason that Mr. Mnuchin said that he welcomes the weakness in dollar perhaps the fact that there is a repatriation tax cut? Thanks to this tax reform, the tax rate on domestic remittances of overseas retained earnings of US companies already accumulated (estimated at about 300 trillion yen) has been lowered from 35% to 15.5%. As a result, demand for huge remittances to the United States and also demand for dollars is expected to be boosted, but at the moment it seems to have been held in check so that it would not result in excessive dollar appreciation. If the dollar rises in response to the transfer of overseas retained earnings to the United States, the US parent companies' converted dollar receipts will be depreciated, and so the US tax revenue will be reduced. It is therefore conceivable that the policy can be viewed as being a way of avoiding this outcome.

Leaving this point to one side, the dollar's rise is desirable for the US in almost all respects. On the day after Mr. Mnuchin's comment on the dollar's depreciation, President Trump came up with the view that 'the strength of the dollar is appropriate for the strong US economy, and a strong dollar is in the national interest of the US' (Mr. Trump's view on the exchange rate has evolved greatly in one year !!). It looks likely that this represents the true nature of the US government's attitude to the issue. (Strategy Bulletin No. 195)

**An unprecedented environment conducive to a stronger dollar**

stronger dollar is more firmly aligned with US interests now than at any time since the transition to floating foreign exchange rates. There are several reasons for this view. First, there is a mutually complementary division of labor within the international division of labor. US companies with monopolistic influence are gaining control over global markets. A stronger dollar will probably enable the US to make purchases at lower prices and make sales at higher prices (an improvement in terms of trade). Second, Trumpnomics will increase inflationary forces, just as Reaganomics did. Third, a stronger dollar will better enable US multinational companies to use M&A and other activities to make acquisitions overseas. Fourth, a stronger dollar will quickly increase the global influence of the United States. For instance, the United States will be in a better position for defense expenditures, will increase its global stature, and raise its share of the global GDP.

The US position within the international division of labor will strengthen to the point where the dollar will not have to depreciate. The competitive superiority of US companies is very clear. For business and personal activities alike, people around the world (except in China where companies abuse intellectual property rights) rely on platforms (internet, smartphones, cloud computing, etc.) of US companies for information network infrastructures. The fact that the US is particularly strong in the financial area is abundantly clear. The overseas retained earnings of large US companies total a remarkable $2.5 trillion in 2015 according to the Wall Street Journal. The size of these overseas retained earnings at US multinationals clearly show that the earnings structure of US companies today depends on direct investments and the export of services rather than the sale of actual goods.

This strength of the United States is producing a big improvement in the international balance of payments. During the past decade (2005-2015), the US current account deficit has fallen from $806.7 billion (5.7% of GDP) to $463.0 billion (2.6% of GDP). Two categories are largely responsible. One is services such as financial services, intellectual property right fees and business services. The other is the primary income balance, which includes items like direct investments and portfolio investments. If the service and primary income surpluses continue to grow at an annual rate of 12.5% as in the past 10 years and the trade deficit remains flat, the United States will switch to a current account surplus after six years. There would be a huge shock if the United States, which has the world's key currency, can achieve a current account surplus. If the United States starts to come close to this surplus, there would most likely be a sudden drop in the supply of dollars from the United States to other countries (Strategy Bulletin No. 173)

## (4) A stronger dollar is bad for China but good for Japan

Most of the negative impact of a strong dollar will most likely happen outside the United States. A strengthening dollar in tandem with an improving US current account balance will make international procurement of the dollar more difficult. Moreover, international liquidity from the standpoint of the dollar will fall as the values of currencies in other countries decrease. This will make it increasingly difficult to procure funds globally. In addition, the global economy will shrink on a dollar-basis and dollar-denominated overseas debt will become more burdensome. Countries will be forced to defend their currencies by raising interest rates. At the same time, countries will have to deal with internal economic problems. All of these events will eventually force countries to increase economic initiatives that rely in fiscal policy.

China will probably experience the most serious problems. First, the strong US economy and dollar along with higher interest rates will exert increasing pressure on capital outflows from China. As the yuan falls, there will be a big increase in the burden created by China's massive external debt, which underpins the country's economy. China's external debt is $4.6 trillion, 40% higher than the country's foreign exchange reserves of $3.2 trillion. This is why the continuation of the dollar's appreciation and yuan's depreciation would be a severe blow for China. Losses incurred by creditors or debtors would be the same whether a debt is denominated in dollars or yuan.

Defending the yuan will be China's only option. But this action is inherently contradictory. Measures to slow the yuan's decline make Chinese products less competitive because the cost of labor in China becomes even higher in relation to expenses in competing Asian countries. Furthermore, actions to defend the yuan result in tight-money policies. But this stance raises the risk of bursting China's real estate bubble and increasing financial instability. Holding the currency steady while stimulating internal economic growth will probably require even more fiscal measures. Since China's financial condition is relatively sound, prospects are good for avoiding a sharp economic downturn over the next few years even if China relies on fiscal initiatives alone to stimulate the economy.

But the currency is not China's only problem. There will also be challenges from the Trump administration's trade friction that targets China. China currently accounts for half of the US trade deficit, making the country the primary target of the Trump administration. We are likely to see criticism of China's unfair trade practices and calls for corrections. Examples of these practices include intellectual property infringements, unauthorized cyberspace access, an extremely closed domestic market, the government's flagrant preferential treatment of Chinese companies, and acquisitions of overseas technology companies while retaining restrictions on investments in China from other countries. Reducing China's imports would be difficult due to the need to maintain a level of internal demand that exceeds the country's actual economic strength. However, there may be increasing difficulties involving China's exports because of a currency that is stronger than the country's actual economic strength and trade friction. This is why declines in the trade surplus and net exports may become another limitation on the growth of the Chinese economy.

**Japan will start benefiting from the strong dollar**

As the dollar appreciates, the beneficiaries are likely to be countries manufacturing products that compete with US goods, especially countries that export automobiles to the United States, and countries that hold US debt. In other words, Japan will probably benefit most of all. Clearly, a weaker yen will significantly boost earnings at Japanese companies by raising yen-denominated export prices. Growth in the value of Japan's external assets will be an even greater benefit. Japan's net external assets are $2.8 trillion, the highest in the world. A stronger dollar raises the yen-denominated value of these assets. For example, a 10% upward move of the dollar would increase these external assets by $288 billion (¥25 trillion). This increase would provide enormous support for the Japanese economy by boosting the value of the principal of Japan's overseas portfolio investments, which are about $4 trillion, and the income from direct investments and portfolio investments. (Strategy Bulletin No. 173)

## (5) The actual goal of the Trump administration is rebuilding American imperialism

The widespread view of the election is that mounting dissatisfaction as the US economy weakened produced a populist administration. But now it's time to correct this stereotypical thinking. Defense, protection and isolationism of a weak America are not the essence of the Trump administration. Instead, President Trump is taking an offensive stance for making superpower America stronger. This blatantly offensive posture explains why the president appears to be so overbearing.

President Trump believes that the world became more dangerous and US economic and military power declined significantly during the eight years of the Obama administration. If this has impacted the US job market as well, then the framework must be altered to make it stronger. Isn't rebuilding US imperialism the best way to express this goal of the Trump administration? Today, the meaning of imperialism differs greatly from the prewar days when countries ruled colonies. The modern definition is an explicit national strategy in which the ability to greatly influence external events is used to further a country's own interests. Only the United States and China have the potential to aim for this type of imperialism.

An empire is divided into two parts: the core region within the home country and the peripheral regions beyond the country's borders. Each is clearly superior or inferior to the other in different ways. The core region is superior in terms of value systems and economic and military power. Imperialism logic says that it is proper for the core to have one-sided influence over the peripheral regions. It is wrong to conclude that President Trump has no strategies simply because he did not talk about values or a global strategy in his inauguration address. The president has a clearly defined understanding of US superiority and is dedicated to preserving and enhancing that superiority. This view differs dramatically from the Obama administration's belief that the United States should stop being the world's police officer and work with other countries to oversee a global commonwealth.

**Returning to the Pax-Americana era**

The question is whether or not President Trump's imperialistic ambitions are correct and if the president can accomplish his goals. If this stance is correct, we should conclude that the goals are within reach. The Middle East is infested with terrorists that answer to no government. China and North Korea are bolstering their military strength. And state capitalism is distorting the foundation for global trade. Problems like these demonstrate the global need for an imperial America that can function as the police for protecting democracy in the world. Moreover, as I have explained in previous strategy bulletins, the economic base for creating an imperial America has never been stronger.

The competitive superiority of US industries has reached an unprecedented level because of the overwhelming competitive advantage the United States has involving infrastructure for the Internet. Earnings of companies (the ability of companies to create value) as well have never been higher. This gives the United States a more than adequate financial foundation for serving as the world's police force. The Trump administration wants to use bilateral negotiations to establish discipline for international trade. Although this appears to be protectionism, it is nothing more than a means of making the industrial base of an already strong United States even more powerful. In other words, this should be viewed as an offensive and imperialistic stance. Obviously, a strong dollar will be both consistent and vital with regard to President Trump's imperialistic ambitious. Some people believe the Trump administration wants a weaker dollar due to its protectionist stance. But this view will have to be corrected eventually. (Strategy Bulletin No. 177)

*(Addendum)*

**A strong currency is a proof of an empire**

*(Excerpt from **"U.S. To Be The Economic Winner And China To Be The Sole Loser"**, by Ryoji Musha, Kodansha ,2017)*

What do you think is the biggest requirement for qualification as an empire? The answer is a strong currency. If President Trump really wants to create an American Empire, there is no reason to talk about a weak US dollar. Markets have always made the strong currencies of countries that created empires, whether in the East or West, strong. One example is the Roman Empire. Today, we can look at the relics of ancient Rome in two ways.

First are the ruins of the magnificent structures created in the core as the infrastructure of an empire. Many aqueducts, colosseums and other stone structures are still in use. Almost all of these remarkable structures are made of stone. The ability to use people to carry building materials and erect these structures unquestionably demonstrates the true wealth of the ancient Roman Empire. The second category of relics is Rome's currency. Even in areas that were on the far edges of the Roman Empire, archaeologists are still digging up the coins of this empire. Moreover, these coins are made of bronze and contain almost no gold or silver.

What is the reason for this large volume of Roman Empire coins in these remote locations? The existence of these coins is proof of the existence of a currency-based economy that covered an expansive area. In that era, people amassed and transferred wealth by using currency. There were no exports from the center of the empire to distant places or any other transactions. That leaves government, military and other services. The conclusion is that currency was used to cover the cost of these services.

Coins that contained no gold or other precious metals but had value equivalent to gold were used by people in remote parts of the empire. This monetary system resulted in the growth of wealth in these locations through the accumulation of coins. Another way of looking at this is that coins made in core Rome, each one probably requiring about one hour to fabricate, were transported to the far peripherals of the empire. People living there exchanged crops that took one year to produce for these coins. A coin made in one hour had the same value as agricultural products made during one year. This clearly demonstrates the remarkable strength of the Roman Empire's currency. Material of coins can be anything. All that was needed was to convince people living in these remote areas that the coins actually had that much value. Consequently, to be qualified as an empire from an economic standpoint, the only requirement is to have a currency that is as strong as possible. Without a powerful currency, completing the process of empire creation is impossible.

Now let's turn our attention to the United States. The country definitely had economic power as well as the world's greatest military power. In terms of its overall strength, the United States has for a long time maintained a level of power that justify calling the country an empire. However, one characteristic was not consistent with the use of the word empire: the dollar's weakness. Under the Bretton Woods fixed exchange rate system, the dollar was worth ¥360. But the dollar was slowly devalued over the years. On September 23, 1985, the dollar dropped about ¥20 in a single day in response to the announcement of the Plaza Accord. The dollar plummeted again about one year later to the ¥150 level. Prior to the Plaza Accord, the dollar was worth about ¥235. This accord was a historic agreement that started a decline of the dollar that continued for many years. The dollar reached its lowest point against the yen in April 1995 at ¥79.75. Afterward, due to steady purchases of the dollar by the Japanese government, the exchange rate was pushed back to ¥147 to the dollar in August 1998.

The picture changed after the 2008 global financial crisis and European sovereign debt crisis sparked by problems in Greece. Investors rushed to buy the yen in order to reduce risk exposure. On October 31, 2011, risk-off sentiment raised the yen all the way to a new all-time high of ¥75.55 to the dollar. This is now the most recent bottom for the dollar. The dollar steadily became weaker for 38 years following the end of the fixed exchange rate system in 1973. During this period of decline, the United States remained an economic and military superpower and served as the world's policeman. But there were many economic and social problems. Examples include the twin deficits (budget and trade), income inequality and the hollowing out of the industrial sector. Finally, signs appeared that the United States may pull back from its role as the world's policeman, which is the duty and responsibility of a superpower. This was the United States up to the end of the Obama administration.

President Trump has been labeled a trade protectionist because he has repeatedly talked about the need for the dollar to depreciate. However, the president may alter his stance regarding the dollar if the advantages of a strong dollar begin to slowly appear as the dollar steadily appreciates. In this case, President Trump may start saying that a strong dollar is in the best interests of the United States. If the president adopts this stance, we can probably conclude with confidence that the United States has at last advanced to the final stage of building its empire.