USD—Unused Implement in the Trade Toolkit

US President Trump's focus on trade and "leveling the playing field" has been intense and is ongoing. Yet two years into his administration's term, the US trade position remains weak, with the US recording the highest trade deficit in 10 years and the widest goods deficit with China on record in October. The data suggest that net trade undercut growth significantly in Q3 and will be a further drag on growth in Q4. Historically, the trend in the USD tends to affect export growth significantly. The USD seems an obvious lever on which the White House could pull to boost trade. However, we rather think the exchange rate will be left untouched in the trade toolkit.

The US trade performance is deteriorating. The October trade report reflected flat exports over the prior month (USD211bn), despite record shipments in energy, industrial and consumer products. Imports rose slightly (+0.2%) over September to USD266.5bn. The unadjusted trade gap with China widened to USD43.1bn—a record—reflecting Chinese importers snubbing US soybeans, among other things.

The 12-month average trade deficit stands at –43.5bn, the widest since 2013, while the 5-year average deficit stands at –50.2bn, the widest since 2009. Both averages stood at –41.7bn and –46bn respectively 12 months ago. Tariffs and the synchronized slowing in global growth help account for some of these trends in US trade and while they may moderate or reverse in the future, little change is likely to emerge in the near-term.

Trade was a significant drag on US Q3 growth, with next exports reducing GDP by a little over 1.9 percentage points in the quarter. That is a huge drag growth. By our reckoning, you have to go back to 1984 to see anything similar or worse. No quarter in more recent times has seen anything close to that sort of negative impact from trade. It is certainly exceptional and possibly a one-off but the weak October report data suggests that net exports are likely to weigh on growth again in the last quarter of the year to some extent at least, accentuating the moderation in the US economy that appears to be underway now.

Given the US Administration's focus on trade—and its tendency to boost the positive impact of its policies on the economy—this may be bothersome, especially as progress on lifting exports is likely to be impeded to some extent at least by the relative strength of the USD. History shows that the USD's broader performance does tend to influence US exports over time and this relationship suggests that an "easy" win for the White House would be to talk the USD lower—the one lever on trade that the president has yet to tug clearly on to gain an advantage for the US.

Of course, it is not quite as simple as that. President Trump—and to some extent Treasury Sec. Mnuchin—have had a flexible perspective on the USD. The president has variously remarked that the dollar was "too strong", a "disadvantage" or that he would prefer an exchange rate that was not too strong. Conversely, the president has also suggest that he "(ultimately)… wants a strong dollar" and praised the "cherished" dollar when talking about foreign investment "pouring" into the US.

Various administrations and their respective Treasury Secretaries have endorsed a "strong dollar policy" with varying degrees of conviction. Those that are less enthusiastic about it have tended to ignore it altogether rather than offer up an alternative. Any clear, obvious and—importantly, for this administration—consistent move away from the strong dollar policy message would very likely prompt a swift drop in the USD.

We think there are a number of reasons why the USD is likely to remain locked away, untouched, in the US trade toolkit, however. Firstly, this administration—like many others before it—has been at the vanguard of promoting market-determined exchange rates. President Trump has been critical of FX manipulation, which talking

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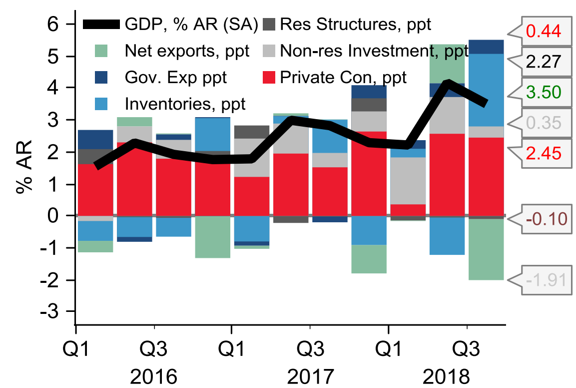
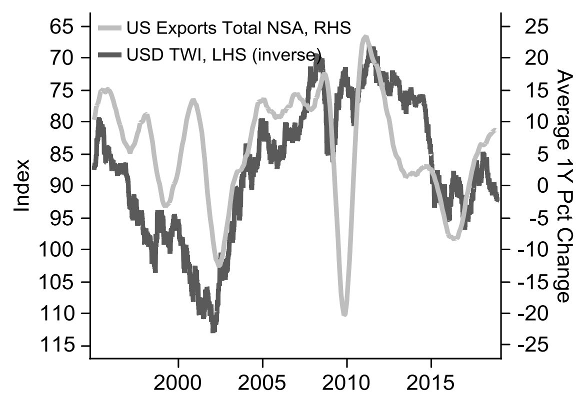
Composition of US GDP Growth



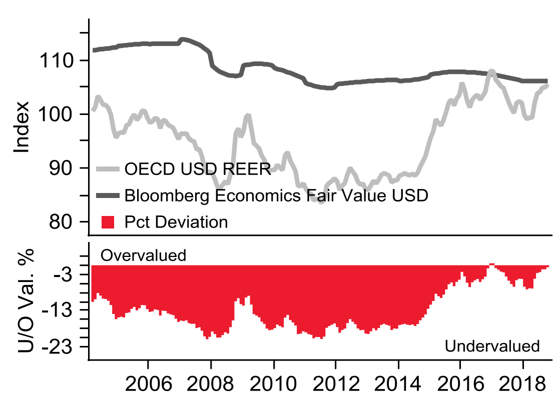
Source: Macrobond, Scotiabank FICC Strategy

Strong USD Will Slow Exports



Source: Macrobond, Scotiabank FICC Strategy

USD Close to Long Run Equilibrium



Source: Macrobond, Scotiabank FICC Strategy down the USD would clearly represent. The US also remains bound by the G7 agreement to avoid competitive devaluations. Secondly, there is the risk of "blowback" or unintended consequences which might result from a weak dollar policy—such as higher inflation, capital flight—which might overshadow the original problem of a weak trade position. Finally, establishing what the appropriate level for the USD might be is not obvious.

In broad terms, for example, the OECD's Real Effective Exchange Rate (REER) index for the USD is close to the longer run REER fair value estimate for the USD developed by Bloomberg. The USD is somewhat overvalued against some of the major currencies in PPP terms but the more egregious currency undervaluation issues largely reside in the EM FX space. Any readjustment here will likely have to occur over the longer run and reflect a sustained improvement in domestic (i.e., non-US) fundamentals rather than simple US jaw-boning the USD lower.