"Buy American" Will Prove Inflationary

- **Business would use American suppliers if they were competitive.**
- **"Buy American" is a policy that will raise prices, not efficiency.**
- **It is meddling in the market and reduces consumer welfare.**
- **It is the antithesis of free markets and entrepreneurship.**

During the long campaign for the White House, both as candidate and nominee, Donald Trump beat a drum that resonated in the areas of America that felt left behind by globalisation and increases in personal wealth.

He declared a plan to *"Make America Great Again!"* by suggesting past administrations had allowed other nations such as China and Mexico to take advantage of America through their lower labour costs and in China's case the dumping of cheap goods.

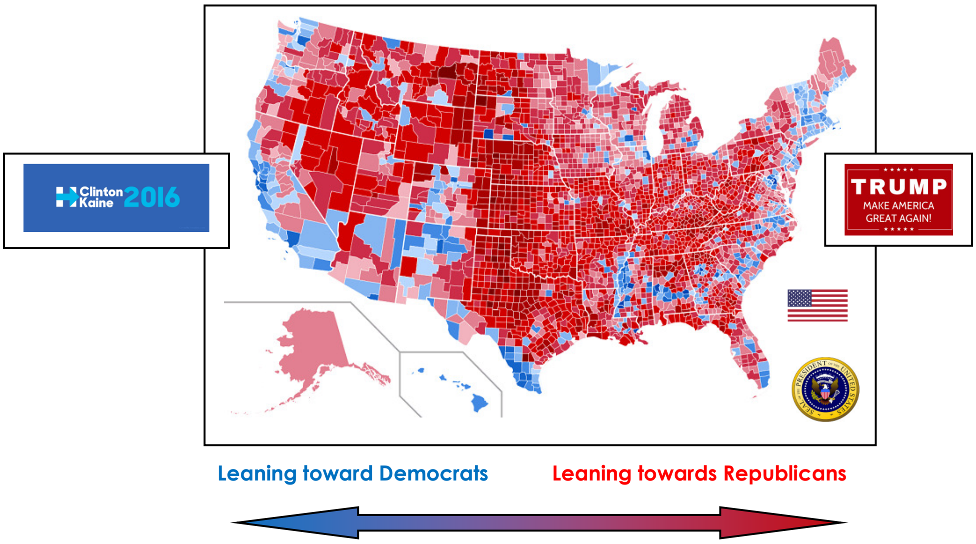

Figure 1: County Level & Vote Share Results of the 2016 US Presidential Election
Source: www.brilliantmaps.com

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He vowed that now idle factories and ghost towns within the *"Rust Belt"* [1] would be brought back to life. Certainly, when one looks at a map of the vote on November 8 2016 at a county level, Figure 1, it is clear his message was heard and met with approval. The map would suggest that the traditional blue collar areas that may have been regarded as safe Democrat territory were moved by the Trump message.

This map explains why Trump was victorious. For despite receiving over 2.8. million fewer votes nationally than Clinton. Her voting returns were highly concentrated in 20 states, especially the along the east and west coasts + DC. In contrast Trump's support came from 30 states as he won approximately 2,600 counties cf. to Clinton's 500. Figure 1 reveals that he won 84% of the geographic US.

The Rust Belt supported Trump largely because many jobs in traditional industrial or mining heartlands had long since disappeared due to inefficiencies, union refusal to modernise and uncompetitive costs.

In short, voters in these areas bought into his message, or rather fell for the illusion that America could return to the good old days. Consequently, once unexpected healthy margins of victory for the Clinton-Kane campaign migrated to Trump-Pence.

A policy that will create price pressure

In his inaugural speech, the new President issued a cry that essentially called for an era of American economic protectionism. The statements on January 20 2017 of...

"...Protection will lead to great prosperity and strength, ... We will follow two simple rules: buy American and hire American. ..."

... were closely linked to the new administrations ambitiously targeted level of GDP growth at 4.0%. This is a level not seen since the wave of industrial renewal in the 1950's and 1960's.

At Spotlight, we disagree with the assertion that he made. In our view, it will simply stoke inflation and inefficiency. To demonstrate why that is the case, one must consider the meaning of *"Buy American"*.

Trump threatens any who do not follow his line

The inference is that American consumers and corporations will be buying American produced goods and services, rather than importing goods made abroad. This issue requires closer examination and we start by considering the corporation and the cost implications for the consumer.

In considering corporate costs, we can see that a firm will undertake certain activities internally and it will obtain others externally through the market...if it is advantageous to do so. If there were no costs whatsoever in dealing with the outside market i.e. it were frictionless, a firm would be structured so that all its process transactions would be with external parties.

However, there are transaction costs that arise from external contracts. These are the cost of seeking out the best supplier, the cost of contract negotiation, enforcement and quality control. Add in a degree of uncertainty which can mean hedging contract risk is appropriate then one can see why certain functions are conducted internally. The cost of internal operations and external transactions will equate to total costs. In Figure 2 the firm will have 50% of its production as an internal operation and 50% as an external transaction.

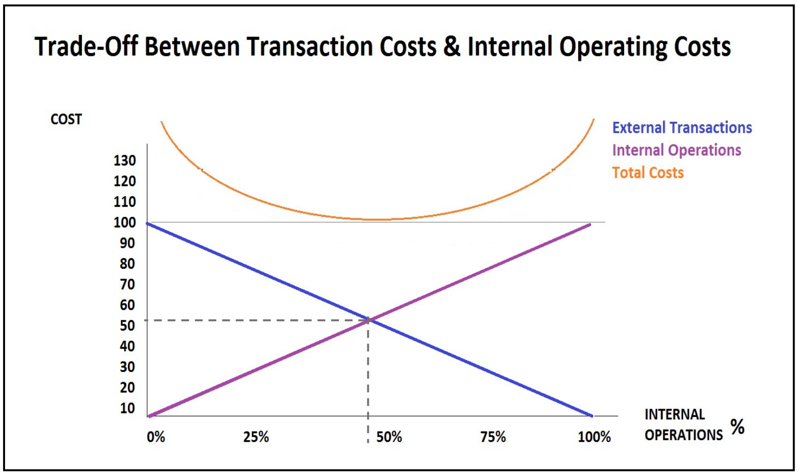


Figure 2: Trade-Off Between Transaction Costs & Internal Operating Costs
Source: Keat & Young [2], Spotlight Education

In looking for external counterparts a key driver will be the cost of acquisition. Therefore, it may well be the case that in the past contracts have been signed with overseas suppliers who prove to be highly cost competitive cf. US providers. In such a scenario choosing an overseas supplier makes perfect sense as C-Suite executives strive to maximise their bottom line and please their shareholders and so boost the share price.

If the new policy of the White House is to press for American firms to use American suppliers or face a penalty it would imply production costs will rise. If there were a currently competitive US supplier in terms of price and or quality, then they would already be engaged as a contractor. If not, then in the short to medium-term any domestic US alternative is going to prove more expensive.

Therefore, if US enterprise has a stark choice, use a domestic supplier that is price inefficient and so face higher supplier costs, or if it continues with the overseas counterpart it will incur a new penalty to be levied, it implies the cost of production will increase; hence total costs will rise.

In this simple model the level of external transaction costs (ETC) and internal operating costs (IOC) plus any foreigner supplier penalty (FSL) will be equal to the level of "Total Costs" (TC) in the expression profit = revenue less costs.

In more detail

Profit = Revenue less Total Costs

$\pi = R - TC$

$\pi = PQ - (FC + VC)$ ***... Profit = (Price per Unit x Quantity Sold) – (Fixed Costs + Variable Costs)***

$\pi = PQ - (ETC + IOC + FSL)$

Note: FSL = 0 if as a switch in suppliers is made from foreign to American so one must consider the magnitude of δETC versus FSL in Dollar terms

Therefore, look at:

$(ETC + IOC + FSL) - (ETC + \delta ETC + IOC)$

$= ETC + IOC + FSL - ETC - \delta ETC - IOC$

$= ETC + IOC + FSL - ETC - \delta ETC - IOC$

$= FSL - \delta ETC$

Therefore if:

$FSL > \delta ETC$ ***Firm will switch to an American alternative***

$FSL < \delta ETC$ ***Firm will stay with foreign supplier***

$FSL = \delta ETC$ ***No real impact, but weigh cost of searching for new domestic supplier with cost of breaking existing contract.***

In all circumstances the firm will face an increase in its costs, Figure 3.

The only way the profit margin can be maintained in the short-run will be if prices are increased to boost revenue. Of course, that will require the firm to be even more aware of the products and practices of its competition and the price elasticities of its product line. So, the policies of "*America First*" and "*Buy American*" may see more activity in the US, or conducted internally but the policies are clearly inflationary in the short to medium-term and consumer welfare will be reduced.

We suspect that Trump will carry on brow-beating and threatening US multinational companies into increasing their operations and suppliers in the US. What a shame he was not so willing to use US workers on many of his real estate construction projects.

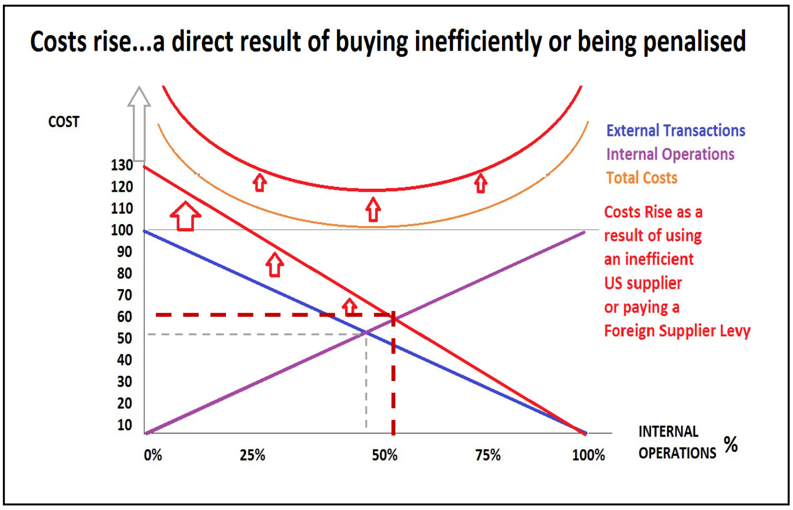


Figure 3: Costs Rise As A Result Of Using Inefficient Suppliers Or Paying A Penalty
Source: Spotlight Education

President Trump has talked about imposing a special 35% tariff on firms that build factories abroad and then sell the foreign manufactured goods back into the US markets. This is a serious case of meddling in free markets and goes well beyond being tough on nations that dump goods into the US.

Such a measure will not sit easily with free market minds in the Republican Party and that may be a sticking point as the President would need Congressional support to get this through. However, the time delay will mean his style of hectoring will simply pile up the level of uncertainty...something that scars and postpones business investment decisions.

Fed could jump the gun on rate rises

The members of the Federal Open Market Committee or FOMC have signalled an intention to increase the Federal Funds Rate (Fed Funds) on several occasions during 2017. The same forecast was issued at the start of last year; yet just one rate hike of 25 basis points (bps) in Fed Funds to 0.75% was delivered in December.

Indeed, if one looks at the closing levels of Fed Funds Futures contracts for Wednesday, February 8 the prospect of a 25 bps increase in Fed Funds in March to 1.00% is priced at just 67.5%. Not until October does the market offer anything like a full expectation. Then the probability in the market is priced at 98.5%.

This would imply the markets are not placing their full faith in the Fed delivering the proposed rate hikes. One doesn't even venture toward a good likelihood of a change until June where an 80.5% probability is priced in. With little in the way of clear economic policy detail as against *"Tweets"* it is at first glance hard to see how sufficient economic traction will be generated to place the Fed in a situation where two hikes after June are justified.

TIPS tea-leaves

One tool that Wall Street is looking to is the spread between standard issue US Treasury notes and TIPS (Treasury Inflation protected Securities).

The yield-to-maturity on a conventional Treasury note (T) pays its holder a fixed nominal coupon and principal. It must compensate the investor for future inflation. Therefore, this nominal yield includes two components: the real rate of interest and the inflation compensation over the maturity horizon of the bond.

For TIPS, coupons and principal vary with the level of the Consumer Price Index (CPI), so the yield includes only the real rate of interest. Therefore, the difference, between the two yields, T – TIPS, reflects the inflation compensation over the relevant maturity horizon.

Having computed TI and TIPS yields, it is straightforward to solve for rates of inflation compensation, or what market participants typically refer to as breakeven inflation rates. These rates are defined as the inflation rates which, if realised, would leave an investor indifferent between holding a nominal Treasury security and the TIPS.

The formula is simplest for the continuously compounded zero-coupon inflation compensation rate:

$$p_t\,(n) = y_t^{\,nom}\,(n) - y_t^{\,real}\,(n)$$

Where:

$p_t\,(n)$ = *Inflation compensation*

$y_t^{\,nom}\,(n)$ = *Nominal Yield*

$y_t^{\,real}\,(n)$ = *Real Yield*

Between 2003 and 2008 the spread at the 10-Year maturity level was approximately 2.35%. This fell dramatically by 2009 as one would expect when economic activity dipped into recession and the spread was barely 0.10%.

On Wednesday, February 8 the yield on the regular 10-Year Treasury was 2.340% and that on the 10-Year TIPS was 0.380% to give a spread of 2.340% - 0.380% or 1.96% = 196 bps.

If inflation did creep higher yield on the regular Treasury notes would rise and the 10-Year TIPS spread would, given historical precedent, be placed at 2.59%. Citigroup points out that the inflation expectations measured by the TIPS spread looks as though it is not recovering sufficiently quickly enough, (i.e. there is a 58.5bps shortfall), for the Fed to deliver the proposed three rate hikes this year.

Therefore, on current conditions it is hard to envisage the Fed being able to raise rates more than twice, most likely in June and again in December. The longer time horizon of inflation expectations on current evidence does not appear to be set to move much higher from the current levels.

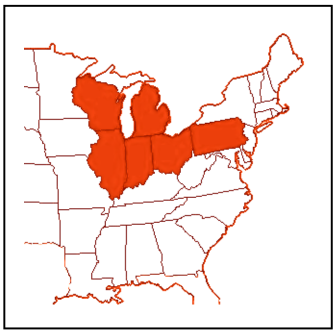
Certainly, the is little pressure from Average Hourly Earnings (AVE), that rose by 0.1% in January of 2017 from a downwardly revised 0.2% gain in December 2016. The January reading was below market expectations of a 0.3% increase and over the past nine years AVE averaged just 0.20%.

Deutsche Bank has issued a similar outlook based on the same reasons and yet Goldman Sachs continue to be positive on the economy in 2017 and have repeated an expectation of three rate hikes this year. The bank said the US entered 2017 with good momentum that indicates a stronger growth path than seen in 2016, i.e. 2.25% in 2017 from 1.5% in 2016.

However, what if the effective Trump tax on business through using inefficient producers or via the levy on those that use foreign suppliers takes hold. That could just give inflation a large enough boost to persuade the Fed that affirmative rate action is required. If so, one will have to hope the economy can handle it.

References:

[1]



The Rust Belt, see the inset, is a term for the region from the Great Lakes to the upper Midwest States. It has been hit by economic decline, population loss, and urban decay due to the shrinking of its once-powerful industrial sector.

Of these states, only Illinois voted for Secretary Clinton, whereas in 2012 all bar Indiana supported President Obama. In his first campaign of 2008 he won the entire region to secure 100 Electoral College votes from the Rust Belt. In 2016 Clinton took just 20.

Source: www.thedebtweowe.com

[2]

"Managerial Economics ~ Economic Tools For Today's Decision Makers"

Keat, P.G. & Young, P.K.Y.

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