

Andrew Smithers' second response to Martin Wolf's column "**Falling dollar saga still has a long way to go**" of 6th December, 2006

**The US Dollar and the need for more US Domestic Investment.**

I suggested in my previous comment that the high growth and low investment ratios of the US and UK in recent years were the corollary of their rising trade deficits and that a reduction in those deficits required either a recession or a rise in the overall investment levels to create tradeable output capacity.

Martin's response was to question the relative capital/output ratios of traded and non-traded goods and services.

I set out some relevant data on this, for which I give many thanks to James Mitchell for his help.

In Q3 2006, US goods' imports (\$1.938bn.) were 30% greater than all its exports (1,420 bn.) and nearly five times US service exports (\$427.7bn.).

<b>Table 1. Average COR in the US Traded and Non-Traded Goods Sectors. 1998-2003.<sup>1</sup></b>			
		<b>COR</b>	<b>p-value for Test of Mean Equality.<sup>2</sup></b>
<b>Traded</b>	<b>Manufacturing</b>	1.560	-
<b>Non-Traded</b>	<b>Construction</b>	0.396	0.000
	<b>Retail trade</b>	0.977	0.000
	<b>Finance, insurance, real estate, rental and leasing</b>	1.095	0.000
	<b>Professional and business services</b>	0.553	0.000
	<b>Educational services, health care and social assistance</b>	1.342	0.001
<b>Weighted average of non-traded sectors</b>		0.919	

<sup>1</sup> The COR is defined as the ratio of the current-cost net capital stock of private non-residential fixed assets to national income. The ratios are derived from the NIPA Table 6.1 for national income by industry, and the "detailed fixed asset tables at replacement cost".

<sup>2</sup> This test shows that the differences in the capital/output ratios are statistically significant. The p-values indicate the probability of accepting the hypothesis that the average COR in the selected industry is equal to the average COR in the manufacturing sector. The test is a so-called ANOVA test based on the idea that, if the sub-groups have the same mean, then the variability between the sample means (between groups) should be the same as the variability within any sub-group (within group).

As Table 1 shows, it takes, on average, 70% more capital to produce output from manufacturing than it does from sectors which are primarily or exclusively non-traded.

From the above data it seems reasonable to assume that the US trade deficit cannot be significantly reduced within a reasonable time frame without an improvement in the balance of trade on goods and that, to avoid recession, this will require a rise in US domestic investment.

The case does not, however, rest on this argument alone. There is also strong supporting evidence in the form of the relative growth rates and investment ratios of the US and UK compared with other G5 countries.

From 1994 - 2004, US and UK investment was 25% below the average of France, Germany and Japan, while their growth rate was almost exactly double.

This can be seen either as a temporary, albeit decade sustained, phenomenon or as an example of the enormous superiority in business of "Anglo-Saxons". If, as we argue, growth with low capital output ratios can be sustained if trade deficits rise, the phenomenon will be temporary; though, as we have seen, it can be sustained for a decade or more.

As the capital income shares appear to be fairly similar, the alternative also requires that the return on capital in the US and UK should be permanently way above that in other G5 countries, without a compensating change in investment levels.

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