Country Risk Review: the US

Country risk

Country risk is the risk firms incur in cross-border investment or lending in a sovereign jurisdiction. Sovereign credit risk is a subcategory dealing with lending to sovereign governments.

Country Risk

Sovereign credit risk
- Key driver of stress in a sovereign jurisdiction
- Rating agency sovereign ratings
- Public finances, external finances, macro performance, economic policy

ESG
- ESG – Environmental, Social & Governance risks
- Quality of institutions (e.g. World Bank governance rankings - WGI)
- Environmental & climate risks, social issues
- Corruption, rule of law, government effectiveness, climate policies / vulnerabilities, inequality & poverty

Political stability
- Assessment of political event risk
- Judgments of probabilities of government overthrow, political violence, social unrest, terrorism, external conflict

Capital controls risk
- Assessment of likelihood of trapped cash in a jurisdiction
- FX reserves adequacy, currency misalignment, trade imbalances, history of capital controls, banking sector strength

Five Country Risk Categories: Low, Moderately Low, Medium, Moderately High, & High risk

Country Risk Review: the US
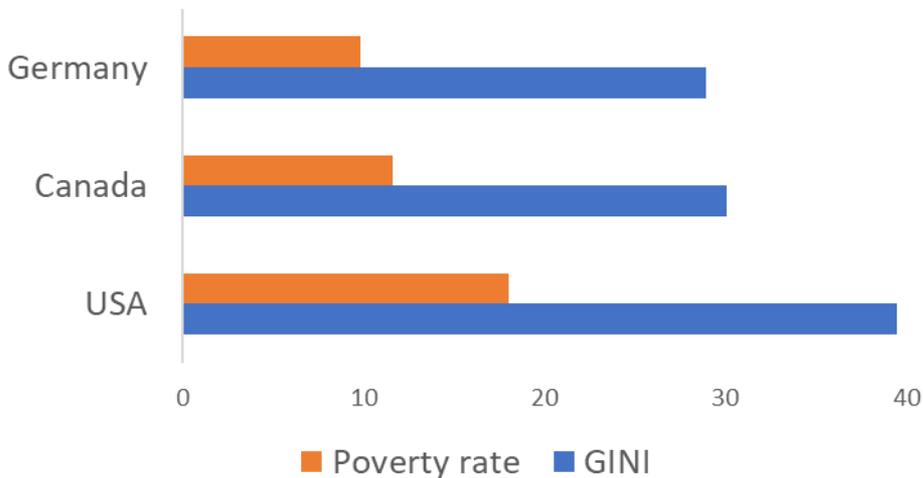
US: a snapshot

Strengths

- World's premier reserve currency

- Wealthy, large, dynamic, diverse economy

- Innovative, leading tech companies

- Mixed performance during pandemic; effective vaccine program

- Strong, but weakening, institutions

- Banking system stronger since GFC

- Credibility of monetary & exchange rate policies

- Population growth & demographics better than in other large countries

Weaknesses

- Political polarization – causes subpar policies

- Public finances – high debt metrics

- Low national savings, high external liabilities

- Reinhart & Rogoff risk – fin. market bubble amid high corp. debt & valuations

- Lack of strategic planning

- Pervasive inequality

- Education outcomes weak – 22nd in PISA exams (33rd in Math)

- Heavy carbon footprint

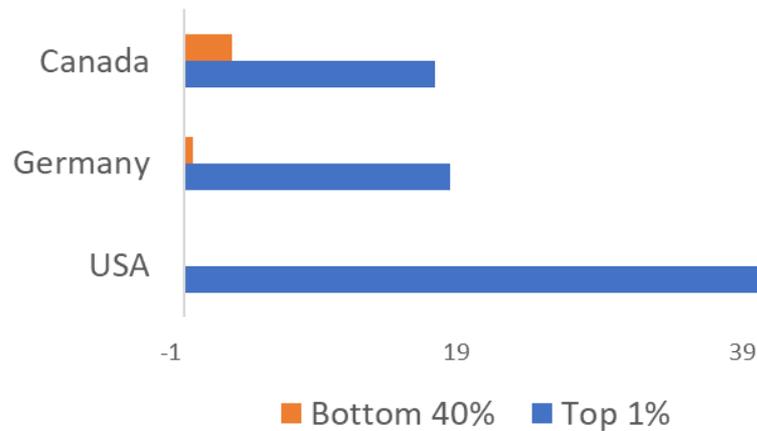- Deteriorating trends - debt dynamics; institutions; education & social outcomes

Inequality: Income & Wealth

Income inequality & poverty

Germany — Poverty rate ~10, GINI ~29
Canada — Poverty rate ~11, GINI ~30
USA — Poverty rate ~18, GINI ~40

Legend: ■ Poverty rate ■ GINI

Wealth inequality
% of net wealth held by wealthiest 1% & poorest 40% of hhlds

Canada — Bottom 40% small positive, Top 1% ~18
Germany — Bottom 40% near 0, Top 1% ~18
USA — Top 1% ~40 (Bottom 40% negative)

Legend: ■ Bottom 40% ■ Top 1%

Notes: Latest data**. Poverty rate** is percent of population falling below poverty line, defined as 50% of median disposable income; **GINI** index is a measure of the inequality of income distribution -- the higher the number the more unequal the income distribution. Both income & poverty are measured after taxes & transfers. **Wealth inequality** shows bottom 40% of households' (bottom 2 quintiles in terms of net wealth) and top 1% wealthiest households' percentage holding of net wealth (wealth minus debt). Bottom 40% of US households have negative net wealth. Income & poverty data are 2019 for US and Canada, 2018 for Germany. Wealth data are 2019 for US and Canada and 2017 for Germany.   Sources: OECD & national governments

Inequality: Breakdown

Unemployment & poverty by race (IMF)
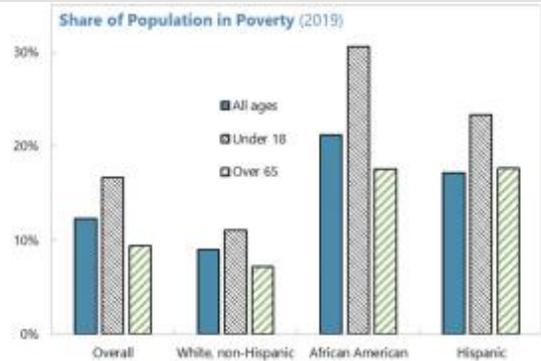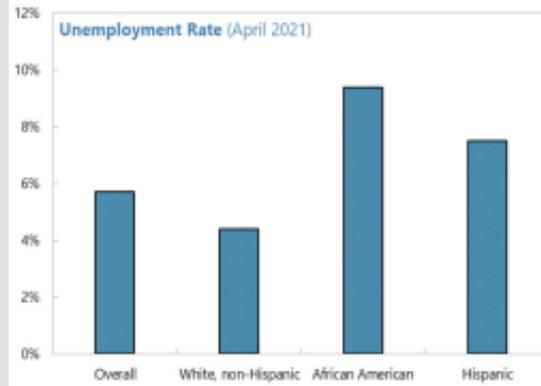
Students with trained math/science teachers, by school characteristics, 2017-18, % (NSF)

School level and teaching field	Minority enrollment (percent)[a]				School poverty level (percent)[b]				Region			
	0–24	25–49	50–74	75 or more	0–34	35–49	50–74	75 or more	Northeast	Midwest	South	West
Middle school mathematics	75	75	63	61	76	73	67	62	75	72	65	71
Middle school science	77	74	79	76	80	78	77	68	82	79	72	77
High school mathematics	88	91	87	83	88	87	91	83	85	91	87	86
High school biology and life sciences	92	87	93	85	92	93	87	87	96	94	81	95
High school physical science	80	78	69	73	84	70	71	71	91	79	60	80

[a] Minority enrollment includes students who are Black, Hispanic, Asian, Native Hawaiian or Pacific Islander, American Indian or Alaska Native, and Two or more races.

[b] School poverty level is the percentage of students in school eligible for free or reduced-price lunch.

Note(s):
In-field subject-matter preparation refers to mathematics teachers with a degree and/or full certification in mathematics or mathematics education and science teachers with a degree and/or full certification in science or science education.
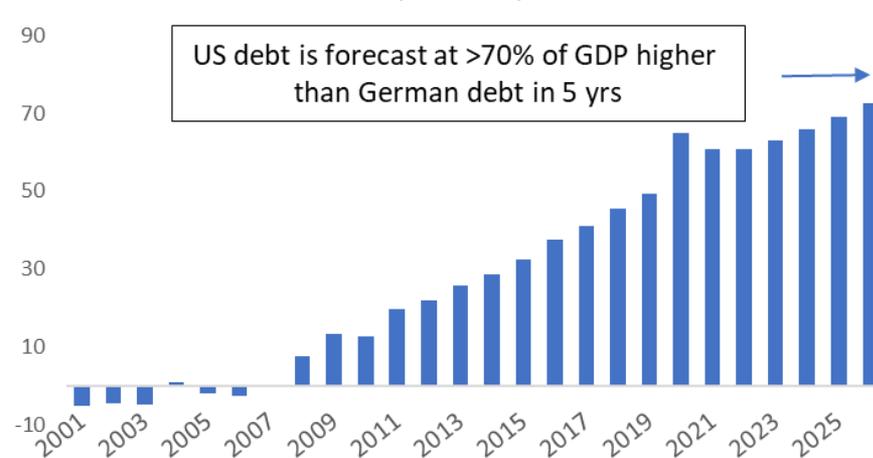
Sources: Racial disparities in economic outcomes in the U.S. as reported in the US IMF Art. IV Staff Report 2021, p. 46. Table showing percentages of students receiving instruction from highly trained math/science teachers by school characteristics is from the US NSF, Science & Engineering Indicators 2021 found here.

NYU SCHOOL OF PROFESSIONAL STUDIES

Low Savings / Rising Debt

National savings (% GDP)
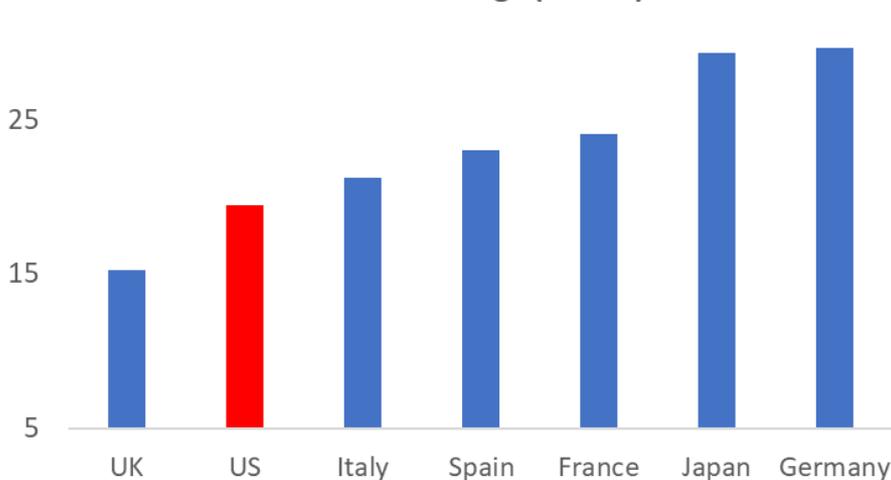
Difference between US & German govt debt
(% of GDP)

US debt is forecast at >70% of GDP higher than German debt in 5 yrs

Sources: IMF WEO, Oct. 2021, incl. debt forecasts after 2020. Savings is 2019. China, not shown in the graph, had savings = 44% of GDP. The current account balance equals Savings minus Investment, or S - I = CAB. 2019 Investment ratios for the countries discussed were: UK (18%), US (21%), Italy (18%), Spain (21%), France (24%), Germany (22%), Japan (26%), and China (43%). US-German debt differential is defined as US General Govt Debt to GDP minus German GGD / GDP (%). US government has a negative contribution to national savings.

NYU | SCHOOL OF PROFESSIONAL STUDIES

Fiscal Policy: a tricky transition…

U.S. debt in 2051: Basecase, Downside & Reform Scenarios (% GDP)
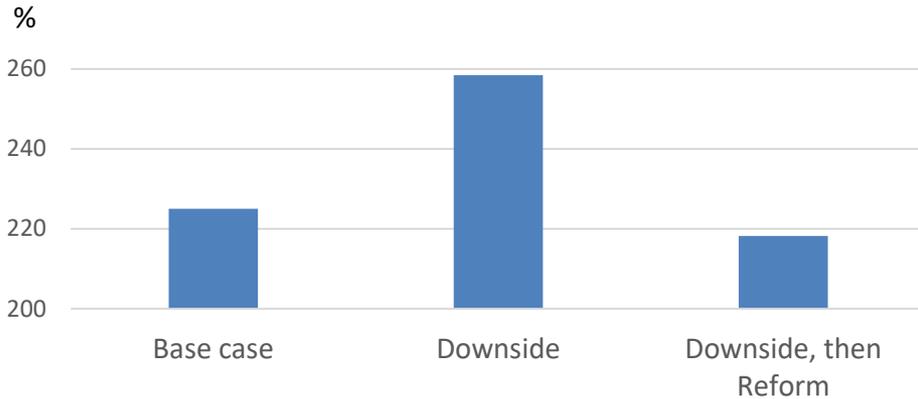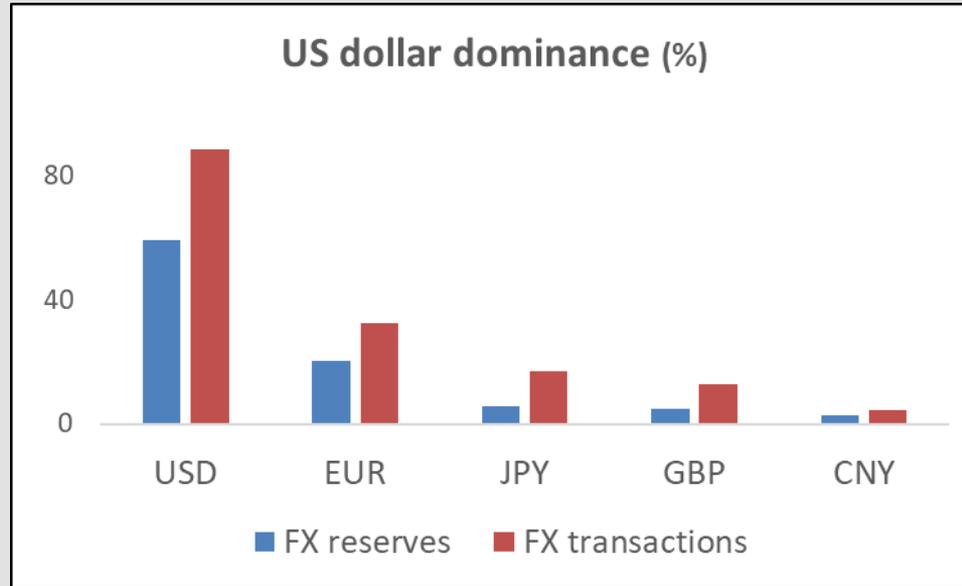

U.S. government debt to GDP could approach U.K. crisis levels
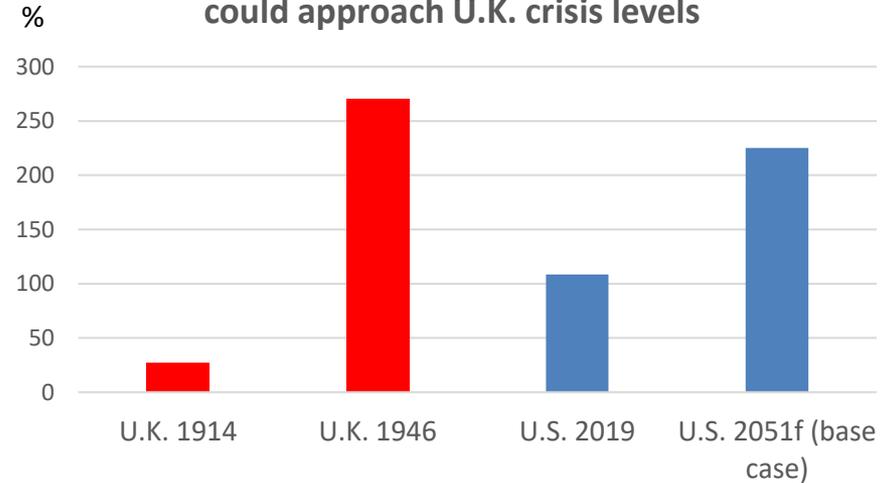
Notes: US base case for 2051 is based on the CBO's LT projections that assume rising entitlements & higher interest rates. It was discussed in the author's **Substack newsletter** , which analyzed the deficit impact of Biden's spending plans. These scenarios have been adjusted to assume Build Back Better is deficit-neutral in the base case, which Biden's FY 2023 Budget, just released, may imply. A downside scenario (driven by a "loss of confidence" in public finances) includes wider deficits and an interest rate shock. A reform scenario envisions deficit cuts & debt stabilization, through modest tax hikes & means-testing, while still funding anti-poverty programs, education & job training, R&D, & green investment. The US enjoys fiscal flexibility given the USD's global role & hence demand for US treasuries. However, Britain fell from grace due to a runup in debt last century, resulting in currency crises in that country. The CBO has produced sound options for **cutting US deficits**. General Government Debt (GGD) = central govt plus states & locals.

USD's unique role provides flexibility…

US dollar dominance (%)

Legend: FX reserves (blue), FX transactions (red)

Categories: USD, EUR, JPY, GBP, CNY

Notes: Ongoing slippage in public finances could ultimately put at risk what **French politicians** years ago called America's "exorbitant privilege". That is, the dominance of the US dollar gives the US a first call on global savings allowing it to fund deficits like no other country can. A reform scenario for public finances could postpone a reckoning for the USD. USD — US dollar; EUR — euro; JPY — Japanese yen; GBP — British pound sterling; CNY — Chinese yuan. Blue bar is currency's % of central bank foreign exchange reserves around the world at 3Q21 (from **IMF Cofer report**); Red bar is currency's % of FX transactions (largely private sector; currency's percentage on one side of all FX trades; sum greater than 1) latest is 2018 — from **BIS triennial survey**. 59% of global FX reserves (allocated to specific currencies) were in USD at end-Sept 2021, vs. 2.7% for CNY; and, the USD was on one side of 88% of all FX transactions in 2018 (latest date available), vs. 4.3% for CNY.

US Negative Net Intl Investment Position (NIIP)…
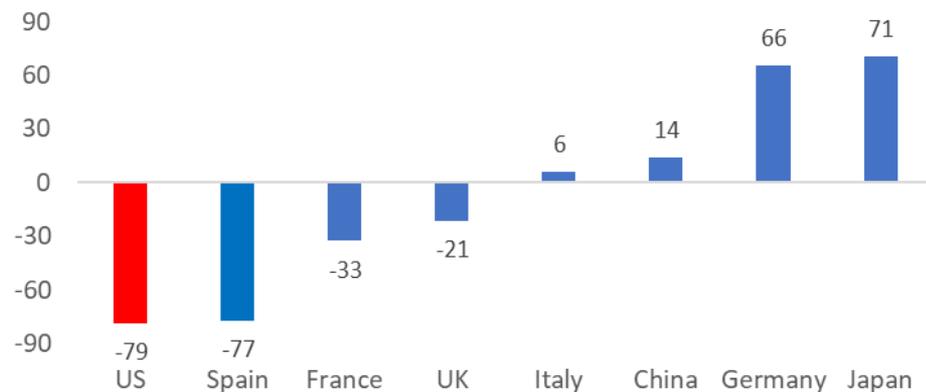...driven by decades of current account deficits,
worsened by tax cuts...
and lately, spending hikes...
(NIIP, % GDP, rhs)

Legend: NIIP % GDP, CAB % GDP. Annotation: Tax cuts
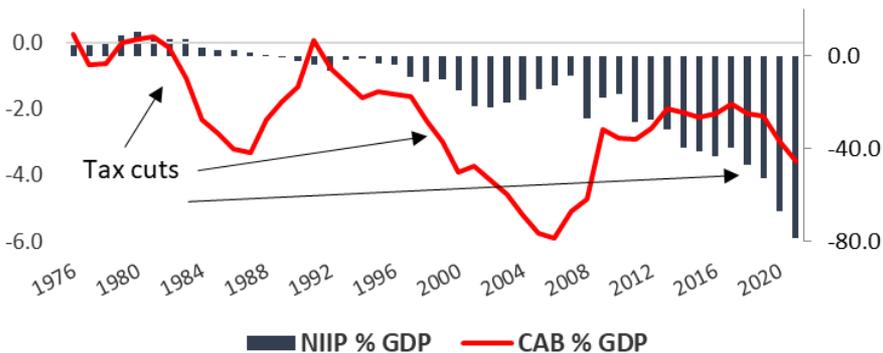
Net international investment position
(% GDP, latest)
It's a country's foreign assets less its liabilities...
A large negative number is bad!

Values: US -79, Spain -77, France -33, UK -21, Italy 6, China 14, Germany 66, Japan 71
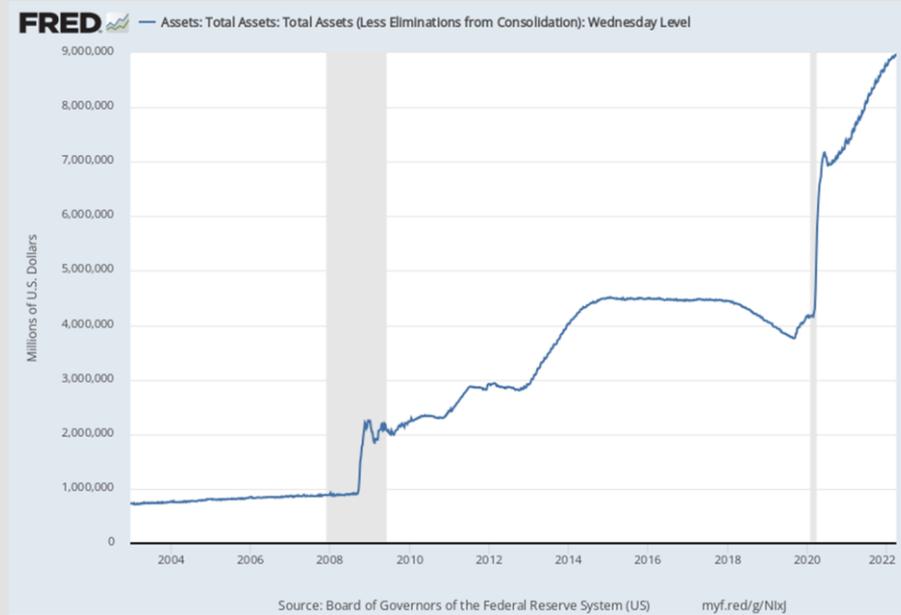
NIIP – US residents' foreign financial assets less liabilities. Annual to 2021, except euro area countries which are 3Q21. Negative number means residents of the US "owe" more to non-residents than non-residents owe the US, due largely to current account (CAB) deficits. CAB = exports and other credits less imports and other debits. US fiscal deficits have been a driver of CA deficits and the rising negative NIIP. This has been driven at times by excessive tax cuts. One reason for the Trump tax cuts' muted effect on US CAB (from 2018) reflects US oil production, reducing net oil imports. Persistent CA surpluses in Japan, Germany & China have yielded positive NIIP values for these countries. NIIP includes equity so is affected by stock prices. The US's negative NIIP widened out a lot to nearly 80% of GDP in 4Q21--the deterioration from 3Q21 due in large part to US stock price increases exceeding those abroad, inflating foreigner's US asset values. Net external debt (NXD), tracked closely by the rating agencies, excludes equity, so is less volatile. Fitch forecasts US NXD/GDP of ~50% in 2021 (sign is reversed in NXD metric).

Fed Balance Sheet
% of GDP; GFC to today

2008	6%
2014	26%
2019	18%
2020	35%
2021	38%
3/2022	36%

FRED — Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level

Source: Board of Governors of the Federal Reserve System (US)   myf.red/g/Nlxj

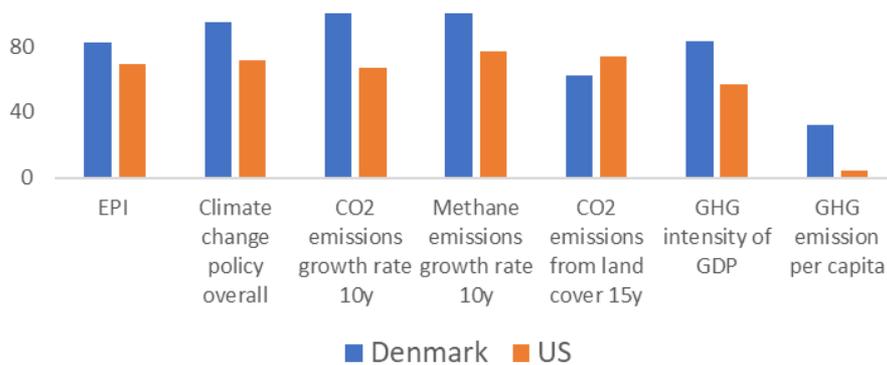**The Federal Reserve has expanded its balance sheet to support the economy**. Fed assets, USD mlns, to 3/30/2022.

GDP = Y = C + I + G + (X – M) = M(s) x V = P x Q When the Fed grows its balance sheet, this should increase the money supply, M(s) and promote growth and potentially inflation (P & Q). Total Fed assets of ~$8.9 trillion = ~36% of GDP as of 3/30/22, vs. ~$900 billion or ~6% of GDP in 2008 before the GFC (global financial crisis).The Fed began reducing its balance sheet in late March 2022, by ~$25 billion in the last week of the month, for the first time since Aug. 2019. Fed asset purchases (of Treasury, agency, mortgage-backed & other securities) have helped de-stress financial markets. But the program has fueled a debt buildup, and -- some believe -- inflation and a bubble in asset prices that could deflate or burst, undermining growth and financial stability. Normalizing monetary policy – by reversing the Fed's asset buildup and raising interest rates – will be tricky, esp. in the context of rising rates impacting sovereign credit risk because of the heavy govt debt burden, as well as negative impacts on growth and financial stability. Some have criticized the Fed as well for being late on combatting inflation.

Low-Carbon Transition: a Lot To Do

US climate policy: EPI performance vs. top-ranked Denmark

(scores, higher is better performance)

Chart categories: EPI; Climate change policy overall; CO2 emissions growth rate 10y; Methane emissions growth rate 10y; CO2 emissions from land cover 15y; GHG intensity of GDP; GHG emission per capita

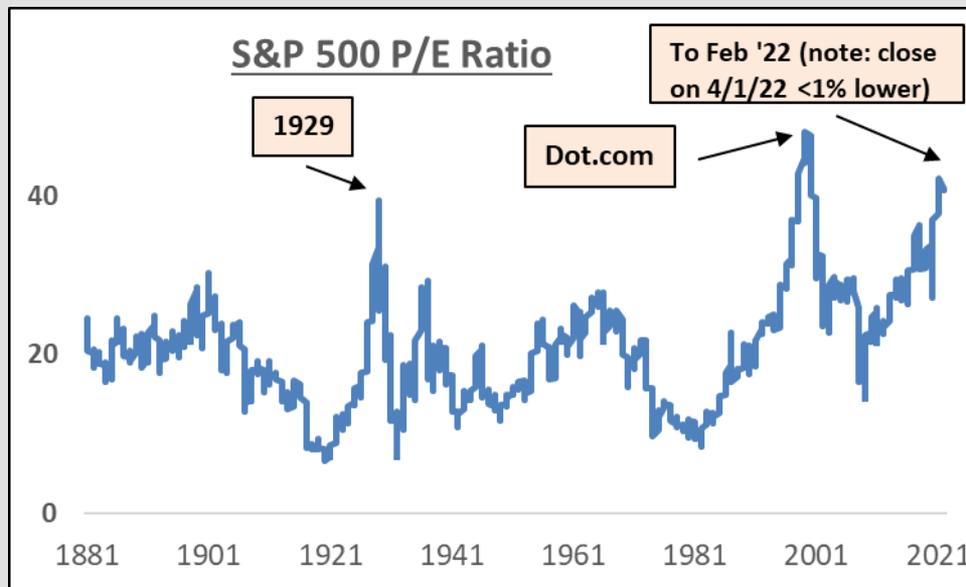Legend: Denmark, US

Sources: EPI, IMF, UN, etc.

US To Do List (goals & tasks):

- US goals: cut emissions by 50% by 2030; carbon neutral power sector by 2035; zero-carbon economy by 2050 (in line with UN goals)
- End tax breaks / subsidies for fossil fuel & GHG-intensive agriculture
- Feebates / rebates on carbon-intensive / low, zero or negative carbon activities
- Regulations: emissions standards; renewables; carbon capture and storage & negative emissions technologies in corporations
- Close coal-fired power plants, retrofit fossil fuel plants for renewables; retrofit buildings to make carbon neutral
- Increase electricity grid capacity & resilience
- Build EV charging infrastructure; mass transit; R&D on electric air travel
- Implement carbon pricing – IMF recommends starting at low $17 per ton of CO2 with annual increases of 9%, vs. Canada's $35 & Sweden's $130 (ramp up carbon price quickly)
- Carbon tax on gasoline, other fossil fuels, etc.
- Promote e-bonds, ESG investing, regulatory requirements on emissions & reporting for banks, corporates
- R&D on battery storage, hydrogen fuel cells, biodegradable plastics & other green tech
- Target EU's 55% plastics recycling
- Join plurilateral UN groups on phase-out of coal, ending deforestation, decarbonizing agriculture, financing LDCs, etc.
- Roll out mitigation plans for wildfires, floods, droughts, etc.
- See Scher: US Climate Action Plan

NYU SCHOOL OF PROFESSIONAL STUDIES

EPI, the Environmental Performance Index is prepared by Yale & Columbia universities; 2020 results
The chart above shows the EPI & its climate components.

Reinhart & Rogoff risk: High equity valuations…

S&P 500 P/E Ratio

1929

Dot.com

To Feb '22 (note: close on 4/1/22 <1% lower)

Notes: **Reinhart & Rogoff risk** (from *This Time is Different*) speaks to debt-fueled financial bubbles. The [Robert Shiller Price-Earnings ratio](#) for the S&P 500 stock index still shows how expensive stocks are. The PE ratio in the graph shows the price of stocks relative to the previous 10 years of earnings (S&P 500 index or other indices in earlier periods). Stocks today are the most expensive they've been in 20 years. Today's PE ratio is around pre-1929 stock market crash levels, but below the pre-Dot.com highs in 2000. Above is a "total return concept" that Yale economist Shiller now calculates. Shiller points out that "changes in corporate payout policy (i.e. share repurchases rather than dividends have now become a dominant approach in the United States for cash distribution to shareholders) may affect the level of the CAPE [PE] ratio through changing the growth rate of earnings per share… A total return CAPE corrects for this bias…"

…and higher business debt…

US Business Debt (% GDP)
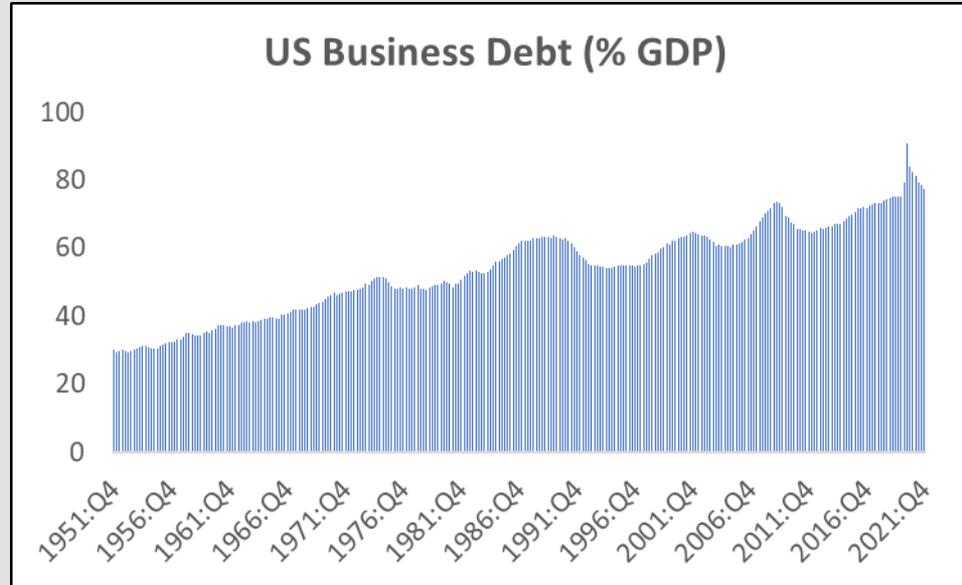
Note: US Business debt as % of GDP remains above pre-pandemic levels, following a decades-long trend rise. Business debt to GDP is from Fed Flow of Funds, March 2022 release.

US: Recommendations

Sovereign rating

- **Foreign Currency Rating of AA+**

  - **USD reserve currency status should provide unique fiscal flexibility for years**

  - **Infrastructure, R&D, green & anti-poverty programs could increase sustainable economic growth**

  - **Fiscal response to pandemic has aggravated govt debt dynamics**

  - **Fiscal dominance could constrain monetary policy**

 - **Further downgrade possible without longer-term plan to cut fiscal deficits**

Country risk category

- **Moderately low risk**

  - **Institutional strengths, flexible & open markets, wealth & innovation have in the past placed US in Low risk**

  - **Policy swings / negative trends on social & education outcomes, carbon emissions & governance argue for Moderately Low risk**

  - **Polarization aggravated by inequality / racial bias**

  - **Violence, notably homicides, higher per capita than in other countries**

  - **Capital controls risk currently low**

  - **Alliance leadership enables US power projection but risks embroilment in conflicts**

Five Country Risk Categories: Low, Moderately Low, Medium, Moderately High, & High risk

Country Risk Index: a longer term view

Ten Point Plan - Country Risk Index: Selected Countries

Country	Country Risk Index		Country Risk Components							
	Rank	Average Score	Political Institutions	Business Climate	Compe-titiveness	Education*	Climate / Environment	Social Progress	National Defense	Sovereign credit risk
United States	14	87	82	97	99	68	73	83	99	93
Denmark	1	92	95	98	93	77	98	99	79	95
Sweden	2	90	96	95	94	79	92	97	75	95
Canada	3	90	93	88	90	90	78	96	89	93
Germany	5	89	90	88	95	75	85	93	93	95
Singapore	15	86	89	99	99	97	49	82	75	95
China	33	67	41	84	80	99	18	39	97	75

Source: Ten Point Plan * China's Education score only reflects exams taken in 4 provinces.

Country Risk Index
Selected countries
Scores 2020, Higher is better
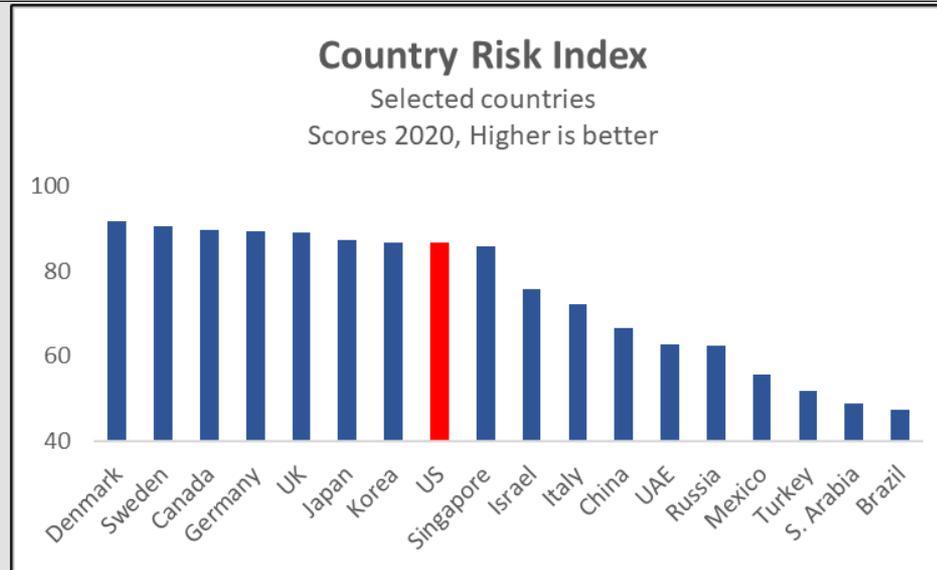
From *Ten Point Plan: Strategic Planning for the U.S.* (Scher/Broide). Index composed of 8 factors: 1) the quality of political institutions; 2) business conditions; 3) global competitiveness; 4) education outcomes; 5) climate & environmental risks; 6) social progress; 7) national defense capabilities; and, 8) the government's financial strength Higher avg score means top rank. See Country Success newsletter.

Prepared by Roger Scher
Country Success   LinkedIn

Country Risk – end