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Economics Group

Special Commentary

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Bring It On Home

Assessing the Potential Impact of Corporate Profit Repatriation on USD

Executive Summary

Since the election of Donald Trump as president in November, there has been a significant amount of uncertainty around the nature of potential fiscal policy changes under his administration. Corporate tax reform is a policy change that appears to be among the new administration's top priorities, which raises the probability that it actually will be enacted. Included in the administration's tax reform proposals is legislation that would allow U.S. multinational enterprises (MNEs) to repatriate their foreign profits at a reduced tax rate. In this report, we aim to assess the likely impact that such legislation may have on the value of the U.S. dollar.

To gauge the likely impact of foreign profit repatriation on the value of the dollar, we first analyze the greenback's behavior in the aftermath of the Homeland Investment Act (HIA), legislation passed in the early 2000s that provided U.S. MNEs with a temporary tax "holiday" during which they could repatriate foreign profits at a lower tax rate. Using the behavior of U.S. firms under the HIA as a guide, we conclude that the currency impact of a repatriation holiday today could be of similar or perhaps greater significance than the effect of flows under the HIA in 2005. The absolute magnitude of any such support is difficult to quantify. However, to the extent that repatriation would be an overall supportive factor, however modest, for the U.S. dollar, it would only reinforce our core expectation of broad U.S. dollar strength in the coming quarters.

Examining USD Behavior After the Homeland Investment Act

Repatriation flows associated with the HIA appear to have contributed to dollar strength in 2005.

In 2004, Congress passed legislation known as the Homeland Investment Act (HIA), which among other measures included a temporary period during which U.S. MNEs with earnings retained abroad could repatriate those earnings at a tax rate well below the prevailing corporate tax rate during that time. Data on the repatriation of profits held abroad of U.S. MNEs show a sharp increase during 2005, when the HIA first went into effect, suggesting corporations used this period as an opportunity to repatriate a sizeable portion of their profits held abroad. During the few years immediately prior to the passage of the HIA, these repatriation flows were running at a rate of roughly $20 billion per quarter. However, these flows increased sharply in 2005 when the tax holiday went into effect, rising to nearly $150 billion in Q4 2005 before subsiding toward more "normal" levels in subsequent quarters (Figure 1).

As Figure 1 shows, the U.S. dollar strengthened on a trade-weighted basis throughout 2005, interrupting a multi-year downtrend that resumed in subsequent years. At first glance, and taking the relationship at face value, this would suggest the repatriation flows may have played a role in supporting the value of the trade-weighted dollar during this period. However, it is also important to consider other factors that may have been influencing the greenback at that time. In particular, the Federal Reserve was raising interest rates as part of a multi-year tightening cycle, a factor which likely had a more significant impact on currency markets. Indeed, as shown in Figure 2, the yield on the 2-year U.S. government bond was rising relative to yields on comparable bonds in foreign economies during that period, which probably was more of an impetus for dollar strength in 2005.

Figure 1

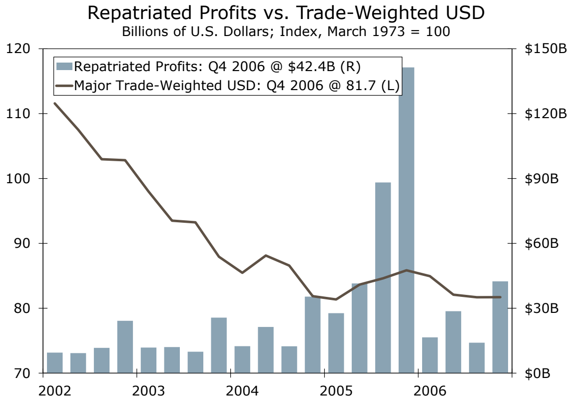
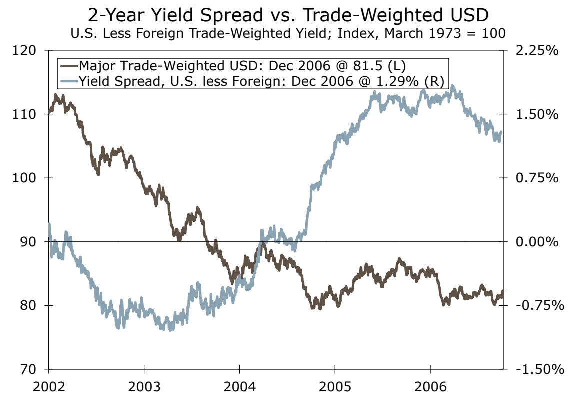


Figure 2



Source: Bloomberg LP, Federal Reserve Board, U.S. Dept. of Commerce and Wells Fargo Securities

To be sure, it is difficult to quantify how much of the dollar's rise during that period can be attributed to each of these two factors, or other factors. One particular consideration that must be made in that context is the *currency composition* of these flows. That is, were these foreign profits held abroad primarily denominated in U.S. dollars or were they held primarily in foreign currency? If these profits were held predominately in U.S. currency, then most of the repatriation flows would simply have been a redistribution of dollars and likely would have had little to no impact on the value of the dollar. However, if the profits were denominated more in foreign currency, then repatriation flows could have been more consequential given the resultant increase in demand for the greenback. Despite uncertainty around this figure, we suspect that the repatriation flows during the HIA had at least a marginal positive effect on the value of the U.S. dollar. In our view, this period serves as a useful guide for potential currency market behavior should similar legislation be introduced under the new U.S. administration.

How Much Could Be Repatriated Under a New "Holiday?"

We estimate that MNEs currently hold about $2.7 trillion abroad.

In order to estimate the likely impact on the U.S. dollar of a potential repatriation holiday in the not-too-distant future, we start with an empirical estimation of the total amount of profits that are held abroad by U.S. MNEs. To our knowledge, this figure is not directly available for 2016, but a letter from the U.S. Joint Committee on Taxation estimates that figure at roughly $2.6 trillion in 2015.[1] Data from the Internal Revenue Service show that foreign-held profits of U.S. MNEs totaled nearly $2.3 trillion in 2012, implying a 4.8% annual growth rate between 2012 and 2015. Applying this annual growth rate to the 2015 figure, we estimate that the foreign-held profits of U.S. MNEs totaled roughly $2.7 trillion in 2016.

We estimate that about $900 billion could be repatriated.

Assuming this figure is broadly accurate, what proportion of these $2.7 trillion worth of profits might U.S. MNEs repatriate in the event of a tax holiday? In order to estimate this amount, we use the 2005 period under the HIA to estimate a "repatriation share"—that is, the proportion of total profits repatriated—which we can apply to the 2016 figure on total foreign profits. We do not have a figure for total profits held abroad for 2005, but we do have a figure for total *assets* held abroad in that year. Applying the average ratio of foreign *assets* to foreign-held *profits* for 2010 and 2012 to the foreign asset figure for 2005, **we estimate that total profits held abroad by U.S. MNEs ahead of the HIA implementation in 2005 were about $1 trillion**. Using the figure we have for total repatriation flows of $300 billion in 2005 implies that about **30 percent of total foreign profits were repatriated during that time**. If we then apply this 30 percent figure to the $2.7 trillion figure for total profits held abroad in 2016, **we estimate**

[1] http://waysandmeans.house.gov/wp-content/uploads/2016/09/20160831-Barthold-Letter-to-BradyNeal.pdf

that there could be roughly $900 billion worth of repatriation flows if legislation encouraging the repatriation of U.S. corporate profits held abroad is enacted.

Benchmarking our $900 Billion Estimate

In absolute terms, our estimate of potential repatriation flows of $900 billion provides little insight into the effect these flows would have on the value of the U.S. dollar. Instead, it is more useful to benchmark this figure against other key economic metrics, including the GDP and external balances of the United States, as well as key measures of foreign exchange market activity. Moreover, by comparing these benchmarked figures to the equivalent figures during the 2005 period under the HIA, we can provide further context around how the U.S. dollar could be affected.

Table 1

Repatriation Estimates

	% of Nominal GDP	% of Curr. Acct. Deficit	% of Daily USD Spot Turnover
2005	2.3%	40%	57%
2016	4.9%	189%	65%

Source: U.S. Dept. of Commerce, Bank for International Settlements and Wells Fargo Securities

Table 1 shows how our estimate for potential repatriation flows in the current period compares to nominal GDP, the current account deficit, and average daily U.S. dollar turnover in the spot foreign exchange market in 2016 relative to 2005.[2] As the table shows, our repatriation estimates for the current period represent a larger percentage of the nominal GDP of the United States in 2016 than the flows that occurred under the HIA relative to GDP in 2005.

The U.S. current account deficit is smaller today than it was in 2005.

Meanwhile, our estimate of $900 billion for the current period is roughly twice the size of the U.S. current account deficit in the year to Q3 2016, while the 2005 repatriation figure represented just 40 percent of the deficit recorded during 2005. In part, this reflects the more favorable balance of payments position of the United States today relative to the middle of the prior decade. Indeed, the cumulative deficit in the year to Q3 2016 was equivalent to around 2.5 percent of GDP, while the current account deficit represented more than 5 percent of GDP in 2005. That said, benchmarking these flow estimates against daily U.S. dollar spot market turnover shows that the currency effect of repatriation today would likely have a fairly similar currency effect to the 2005 period from a turnover perspective.[3]

Putting It All Together: How Will USD Be Affected?

What do these figures tell us about the potential impact of a repatriation holiday under the new U.S administration? First, the fact that our $900 billion estimate would represent a larger portion of the U.S. current account deficit today relative to 2005 suggests that repatriation in the current period could provide **more support** for the value of the dollar than did the 2005 HIA repatriation. Further supporting this thesis is the fact that our estimate for the present period represents a larger share of GDP than did the 2005 flows, while we also note the fact that relative GDP growth trends have been more in favor of the United States recently than they were a decade ago. Indeed, as Figure 3 shows, GDP growth in most major foreign economies continued to climb steadily in the latter half of the prior decade, while U.S. growth steadily trended lower. Meanwhile, U.S. growth is currently showing signs of stabilization and is expected to converge toward growth in the rest of the world this year. Accordingly, broader economic conditions appear to be acting as less of a headwind for the U.S. dollar at present relative to a decade ago.

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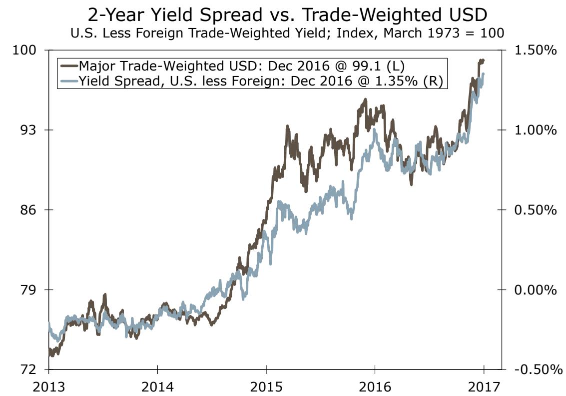
[2] **Current account data for the United States for Q4 2016 are not yet available, so we use data for the year through Q3 2016.**

[3] **Note that this is *daily* turnover. The repatriation of these flows would likely be spread out over a longer period of time, perhaps several years, suggesting they would ultimately be a far less significant percentage of daily FX market turnover upon repatriation.**

Figure 3

Figure 4



Source: U.S. Department of Commerce, OECD, Federal Reserve Board, Bloomberg LP and Wells Fargo Securities

Turning to other metrics, the repatriation sums represent a similar percentage of the relevant FX market turnover figures, suggesting **similar support** for the dollar from a turnover perspective. In addition, monetary policy trends are currently working in favor of U.S. dollar gains, as was the case during 2005, with the U.S. yield advantage over its major trading partners moving sharply in favor of the greenback in recent years (Figure 4). Accordingly, the empirical evidence would in our view suggest that a new repatriation period would have either a **similar or perhaps greater positive impact** on the dollar than was seen in 2005.[4]

As a final note, we acknowledge that the proposal from legislation put forth by the Trump administration suggests not just a one-time tax “holiday” on profits held abroad, but also a more permanent change in tax policy in which the profits earned abroad by U.S. MNEs would be taxed *as they are earned* regardless of whether they were repatriated or not. That said, while that additional facet may or may not have significant implications for the behavior of these MNEs during the “tax holiday” period and the effect on currency markets, such a fundamental change to tax policy may have ongoing implications for the U.S. dollar to the extent that it alters corporate decisions on whether to hold foreign-generated profits abroad or bring them back to the United States.

In our view, repatriation flows associated with any corporate tax reform should support the value of the dollar.

In all, the likely impact of a new repatriation period on the dollar remains highly uncertain, and quantifying that impact requires analysis that we acknowledge is fairly imperfect. That said, despite the uncertainty around the **magnitude** of the currency impact, the **direction** of the impact is more certain, in that any such capital inflow should provide some support to the greenback, however marginal. In that regard, should Congress enact legislation to encourage the repatriation of U.S. corporate profits held abroad, it would support our continued expectation of further U.S. dollar strength over the medium term. To be sure, this view is primarily predicated on the outlook for further monetary policy divergence, as the Federal Reserve continues to raise interest rates while most other global central banks maintain more accommodative policies. As we get more clarity around the likelihood of legislative measures on repatriation, as well as the scope of any such measures, we will consider the need to reassess the extent of dollar strength in our forecast accordingly.

4 For the purposes of this analysis, we assume the currency composition of foreign profits remained broadly similar between 2005 and 2016, and thus that this would not represent a differentiating factor in terms of the relative impact on the U.S. dollar’s value during these two periods.

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