U.S.

Economic Watch

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Economic Analysis

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Repatriate Games

Implications of a Second Homeland Investment Act

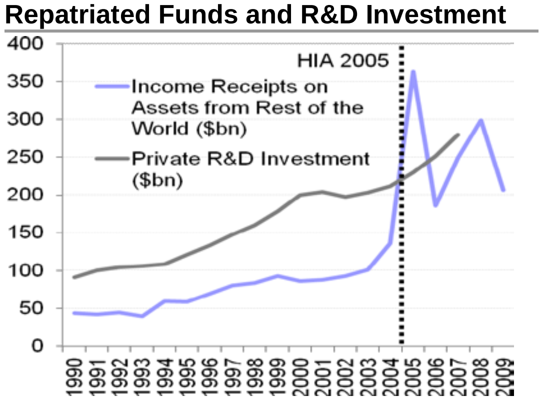
- **An estimated $600bn in flows would largely go to dividends and buybacks**
- **This would essentially act as a third asset purchase program, but the effects would be miniscule for growth and may increase financial vulnerability**
- **Oil & fiscal concerns may cancel out appreciating effects on dollar**

For all intents and purposes, proponents of a tax break on repatriated profits acknowledge that back in 2005 most repatriation went to share buybacks and dividends to shareholders. The hypothesized investment in training, plant and equipment did not materialize, and proponents of the tax break do not expect a different outcome. However they claim that dividends and share buybacks are just as good: the wealth effect and flow of money to shareholders will directly inject confidence and spending power into the economy. Moreover, this stimulus is a free lunch in that the government benefits both from direct taxes on the inflows of repatriated sums and indirect taxes on dividends, although the Joint Committee on Taxation originally projected an offsetting tapering of tax revenue in the following years. From a political standpoint, Obama administration officials are unlikely to approve this tax break without including it within a more comprehensive tax overhaul. Given the one-off nature of this tax break, a more efficient solution to improve U.S. competitiveness would involve a reboot of the tax code. Legislation, it is important to note, is always uncertain and often falls short. We review this tax break along (1) financial constraints, (2) economic conditions and (3) flow effects.

First, are the financial constraints facing multinational firms radically different from 2005 to justify the constraint-lifting effects of a tax break? Debt reduction and financial constraints are all unlikely drivers of the use of these repatriated funds. Firms are refinancing record levels of their long-term debt given ultra-low interest rates and cash holdings are at high levels. Indeed, some preliminary 10Q4 statistics released in February by S&P suggest share buybacks are en vogue. S&P expects buybacks are roughly 50% ahead of 09Q4 and slightly above last quarter. S&P also believes that the overall share count will decline by 1.6% YoY. Another likely use of funds will be for merger activity, which may speed industrial restructuring in the US or accelerate industrial concentration.

Graph 1

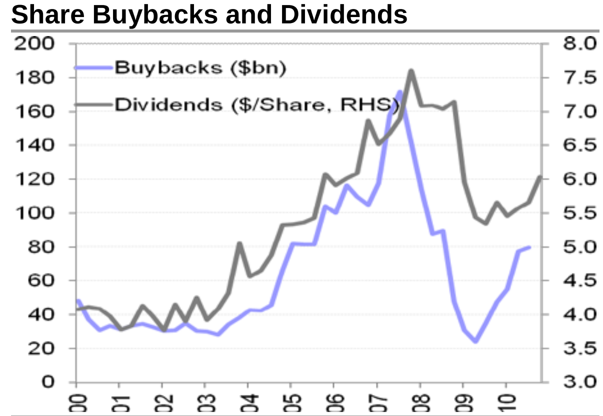
Repatriated Funds and R&D Investment



Source: BEA and Haver Analytics

Graph 2

Share Buybacks and Dividends



Source: S&P and Haver Analytics

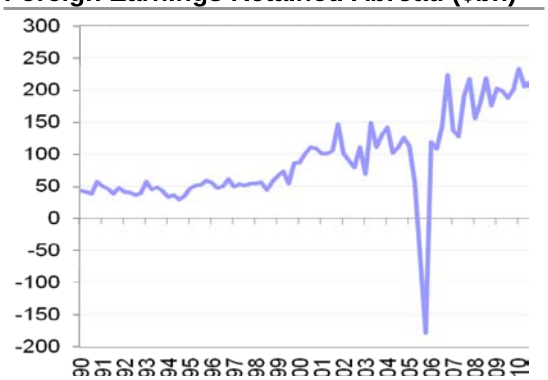
Second, are economic conditions supportive of this kind of stimulus? Although not explicitly stated, one benefit of the Federal Reserve's large scale asset purchases (LSAPs) was to increase the net worth of households, improve their pension balances and generally create a confidence-enhancing wealth effect. Repatriated profits, given their bent towards share purchases, would be akin to QE3, except without the portfolio balance effect that the Federal Reserve's purchase program designed. When the Fed conducts LSAPs, it removes duration from the financial system and steers investment portfolios towards long-term investments in non-government securities. Also, it is certain that there will be even less control over this LSAP than the Fed-organized LSAP. Even the Fed acknowledged it cannot 100% control the effects of LSAP and it holds numerous policy tools.

Furthermore, when billions of repatriated funds arrive in the US, they will merely push up asset prices. In this case, corporate assets today are probably valued at a comfortable level. In contrast, residential asset prices persist as a major issue. Households still do not have a clear direction of home prices and residential investment is a drag on the recovery. If anything, this kind of equities LSAP is focusing on the wrong kind of assets. This would be a good idea when asset prices are beaten-down, but given the rapid recovery in major stock indices, the marginal benefit of more wealth effects is likely to be small and may instead increase vulnerabilities in the financial system. Additionally, dividend income is highly centered in the top quintile while the spending elasticity tends to be lower than most other income sources.

Lastly, what kind of flows should we expect and what will the impact be on the dollar? According to BEA statistics, the first tax break for repatriated profits (the Homeland Investment Act, or HIA) generated some inflows of roughly $300bn. Industry proponents will claim up to $1tr in flows from a second HIA, but this is most likely a vast overstatement given the natural bias of lobbyists. However, they are correct to assert that the flows will be greater than in 2005, since foreign earnings retained abroad are running about double the quarterly flows of 2005, according to the Federal Reserve. A simple extrapolation will predict around $600bn in flows as a result, if companies make exactly the same decisions as they did in 2005 but with simply twice the scale. We do not know the currency distribution of holdings, but it is reasonable to expect that not all overseas profits are held in dollars. This implies a substantial additional spate of dollar purchases over 2011 that will be bullish for the dollar. In addition, the Fed will end its quantitative easing program in 10Q2. This depreciating effect on the dollar will end.

However, there are two factors that will pull against the dollar at the same time. First, inflationary pressures will create depreciating influences on the dollar, especially if political conditions in the Middle East North Africa worsen. Second, the fiscal situation in the United States will become an increasingly important driver of the value of the dollar as the government's credibility in meeting reform targets will wax and wane through legislative give and take. Overall, these two factors may wash away the appreciating effect of a second HIA. In any case, growth differentials will imply that the foreign exchange rate dynamics between emerging markets and the dollar will be different than that with developed countries.

Graph 3
Foreign Earnings Retained Abroad ($bn)



Source: Federal Reserve

Graph 4
Flow-Weighted US Dollar Index

Source: Haver Analytics

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