The Dollar and US Exports

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For the next five or six quarters, the trade balance is going to look much better. Growth momentum overseas will generally support our exports until more of the international bubbles break. Our trade will also be aided by a dollar which is grossly undervalued relative to the euro, the British pound, the Swiss franc, and several other currencies. The dollar is still overvalued relative to the key Asian currencies. As a result, much of our export improvement will come at the expense of Europe. Europe will become more agitated about that situation as the extent of the credit and economic problems in Spain and elsewhere in Europe become more evident, and we will hear more complaints about "beggar thy neighbor". Our imports will continue to be dampened into early next year by the collapse of the domestic US credit bubble. Even our trade situation with respect to Asia, China in particular, may be eased by a forthcoming Chinese decision to revalue the yuan more rapidly to ease their own domestic inflation problems. But our trade improvement is not likely to go as far as it should because of the political and professional economic obsession with domestic demand, and with the US "responsibility" for being the "consumer of last resort for the world." We have already begun the process of redefining the bubble peaks of home ownership and credit access as "normal." We are ignoring the obscene credit abuses involved in the SIVs and such mortgage lenders as Thornburg Mortgage (leveraged 20 times on mostly short term debt), and have begun to redefine them as victims of the "subprime crisis."

Although the majority of consumer spending is non-cyclical, we are hearing the usual mantra that we have to help the consumer because the overall consumer is 71% of the economy, and consumer weakness cannot possibly be offset by exports which are only 12% of the economy. That is nonsense, but it is a declaration that is all too frequently made in the financial, commercial, and political communities. Exports can be a dynamic source of employment and incomes that support the economy as well as housing and consumer durables. But, our political and institutional structures overwhelmingly favor credit for housing and consumer durable spending, and significantly underemphasize credit and other structures to support exports.

We have some outstanding exporters, which vary in size from the mega-capitalized firms such Boeing and General Electric to the small cap firms such as Millipore and Pall Corp. Most of our major banks have international trade and finance facilities that can either directly facilitate transactions, or that can work with the Ex-Im Bank. My banks can handle anything that a client

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needs, if the client is anxious enough to pursue it. But, those facilities have been so secondary and so subordinated within the US banking structures relative to more fashionable lending that to stay in export finance, an individual banker has had to really love international business. The best career opportunities have been where the federal government has been easiest and most promotional, and that has been in structured domestic credits, where we have had the recent bubbles. The gap between what we have in export talent and finance and what we need cannot be replaced by hedges. And, we can no longer safely assume that we do not have to push our exports because other "locomotive" countries will eventually pull them in, if only we are patient enough.

Export customers generally prefer to finance their purchases in the currency that best matches their revenue stream, and at a maturity or duration that is appropriate for the good or service purchased, or that best balances their overall financial risks. That risk management desire has, in the past, created opportunities for trade management mischief by other governments or foreign banks. At times, local financing has been available only if a purchase is made from a favored local supplier. To get around that potential barrier it would be helpful if export finance were more readily available in any of the major trading currencies. In theory, that could be created synthetically, by the buyer or seller, with hedges. But, we should have learned from the experience of the past year that not everything can be hedged, or hedged effectively. The use of hedges to replace normal finance has, at times, bordered on the arrogant, or the suicidal.

If we, the United States, were a normal country, and if we had a normal central bank, with normal central bank responsibilities and authorities, we would be placing far more emphasis on balancing the international financial position of the United States. If we were to do that, we would not have as much to worry about from the rest of the world, and the world would not have nearly as much to worry about from us. The world is not decoupled from our demand. The world is not decoupled from our inflationary policies. And, both of those points are going to become much more evident during the next twelve months.

I am reluctant to criticize the Federal Reserve Board during a crisis. During a crisis the Fed's first responsibility is to stabilize the system, and that may mean taking more inflation risks for 2009-2010 than we would like, if we had a choice. The Fed is currently taking appropriate steps

to deal with the immediate crisis. But when things do finally calm down, some serious questions should be asked about the performance of the Fed since 1998, particularly about whether they have repeated all or nearly all of the mistakes of the Burns-Miller era. The Federal Reserve Bank of New York did not perform its market oversight role very well. It is that role that justifies its special position in the Fed structure. The NY Fed seems to have been somewhat negligent with respect to the asset backed commercial paper market, where we have had a repeat of the 1970s' mistakes, and with respect to the use of SIVs by banks to conceal leverage and their actual risk profiles. And, the overall Fed seems to have suffered from the same definitional fetishes that crippled the Fed in the 1970s. We hear too often that inflation expectations are "well anchored." We too often hear Phillips Curve explanations for current inflation, suggesting that it is a temporary cyclical condition that will be corrected as the economy cools, and ignoring the money and credit excesses that underlay the current US and global inflation problem.

Definitional fetishes have always been part of Fed watching. Money supposedly isn't money unless the Fed says it is. And the most important M definition seems to be the one that the Fed says is important at the moment. Nearly forty years ago, we stood around the Dow Jones broad tape at 4:18 every Thursday afternoon waiting for the release of the money supply and reserve data. At that time, the then current definition of M1 was most important. We then shifted to M2. Then we redefined M1. Then we shifted to M2 plus. Then we shifted to M3. Each time we shifted, we were trying to find a better proxy for credit, which was the real Holy Grail. Pure monetarists tried to anticipate the Ms by focusing on adjusted Federal Reserve credit, currency outstanding, and the monetary base. But, even with them, there were definitional disputes among and even within the regional Reserve Banks. International transactions and offshore dollar accounts often distorted the measures and the adjustments. Credit was always a more reliable measure than any of the definitional monetary fetishes of the moment. Whenever credit grew much more rapidly than potential GDP, beyond the initial recovery from a slump, there would be inflation and there would be a bubble. And, the bubbles would generally be most severe with respect to the "risk free" fad or the bottleneck of the moment.

It has been a mistake for the Fed to emphasize core inflation. That has been a definitional fetish. The core inflation concept works for a closed economy which experiences weather shocks. It does not work well for an open economy which is the reserve currency economy and which has experienced a competitive devaluation, in the 1930s sense of that term, by a major trading partner. China executed, implemented, and fully exploited a competitive devaluation of its

currency in 1993-1994. Although the impact of the Chinese currency change first progressed in slow motion because they initially lacked both capacity and infrastructure, its cumulative impact on prices and incomes in the United States, and in other countries, particularly in Japan, has been quite significant. Competition from China has reduced prices for consumer finished goods while increasing prices for most commodities. Competition from China has dampened wages and incomes of production workers as capacity and production have been shifted from New York, Pennsylvania, Ohio, Indiana, Illinois, etc., to Guangdong, Fujian, etc. Core inflation has been held artificially low while incredible pressures were developing in the energy, industrial commodity, and food areas, which were, of course, made much worse by Congressional actions which restricted potential energy supplies and inflated agricultural demands. When the Fed tries to **reflate** demand, they will have to validate the costs being experienced by the average worker, just as Burns and Miller did in the 1970s. Or, they will have to pass the buck and call for new fiscal policies to encourage investment, efficiency, and productivity, just as Miller did in 1978-79 when faced with a similar cost structure.

It was also a mistake for the Fed to ignore the rapid accumulation of foreign reserve holdings at the New York Fed, without counting those holdings as part of the US monetary base. When a retailer buys goods from a supplier, the money does not leave the system. The money goes to the account of a wholesaler or an importer, and then to the account of a producer. In the case of imports, the money may go to the account of Pudong Trading Company, and then to the account of Cherry Motors. But, if Cherry Motors needs renminbi yuan to pay its workers and suppliers, it sells its US deposits to the Peoples Bank of China. The PBoC transfers the deposit from JP Morgan Chase, or where ever, to the Federal Reserve Bank of New York, where it is used to buy Treasuries and (housing) Agencies. In the process, the ownership of Treasuries and Agencies has notionally shifted from the retailer or its bank to the ownership of the Peoples Bank of China. If the entire transaction had been with a domestic supplier, there would have been no change in domestic money supply. But, because a foreign supplier and a foreign central bank have been involved, we have allowed a definitional fetish to treat the final transfers as a disappearance of money. When the money is transferred from a US bank to the Peoples Bank account at the Fed, it falls off the money measurement system and into the footnotes of the Fed, into the Fed's own Super SIV, without reducing credit to the US economy. While Federal Reserve Credit and Monetary Base appear to have grown slowly during recent years, that is only because foreign central bank deposits at the Fed have been excluded by the definitional fetish.

Central bank credit to the US, both Fed and foreign, has fully supported all of the speculations that we have experienced, and has been excessive.

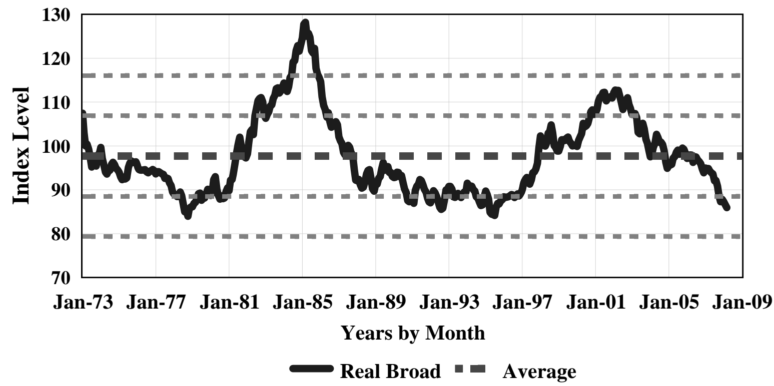
Since George Romney tried to pressure the Fed to favor housing thirty-eight years ago, the Fed has argued that credit was fungible, and that any such tilt would be at best temporary. But, because of the credit structures such as FHA, GNMA, FNM, FRE, and housing SIVs that we have institutionalized and bloated, and because of the bias in the Basel regulations in favor of housing credit, we have tilted everything in favor of domestic demand, and managed to conceal many of the funding sources for what we are doing.

I do not believe that the Fed currently has the legal authority to manage the international financial side of the US economy to the extent that they could choose to be easy, neutral, or tight with respect to domestic credit demands, while choosing, separately, to be easy, neutral, or tight with respect export credit demands. But, historically, other central banks have had such separate authorities, and have been able to use them effectively to manage domestic demand, international balance, domestic inflation, and reasonable currency stability. We have been spoiled by our reserve currency status, our domestic demand obsession, by our Cold War desire to subsidize every potential foreign ally, and by the idea that we should be the consumer of last resort for any other country in trouble. Some day we will have to grow up and realize that the world is changing, that we are just another country, although still one of the most important, and that we will need to export something beyond Boeing aircraft, ownership of reserve accounts at the NY Fed, and pieces of green rag paper in order to import the things that we will need. The new balance of power that is emerging in the world does not favor our old monetary and fiscal policy approaches, and we can no longer afford to repeat the same old mistakes.

Although there is no reason to believe that we cannot balance our trade, stabilize the purchasing power of the dollar, and restore the growth of our output and employment, I fear that we are preparing to repeat all of the old mistakes at least one more time.

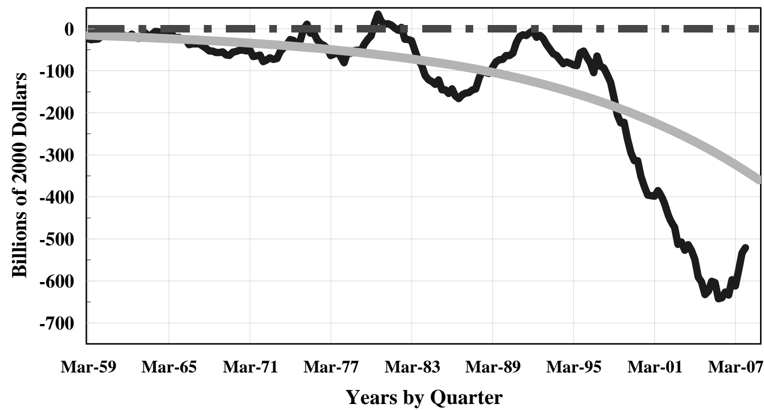
The Real Broad Currency Dollar Index

Plotted With Average (97.723) and Standard Deviations (9.219)



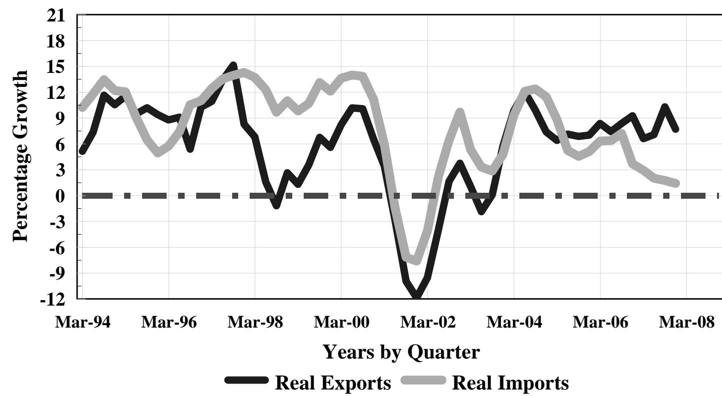
Real Balance of Trade in Goods and Services

Plotted with Trend Caused by Systematic Overvaluation of Dollar
Chain Weighted 2000 Dollars



Growth of Real Exports and Real Imports

Year to Year Percentage Changes



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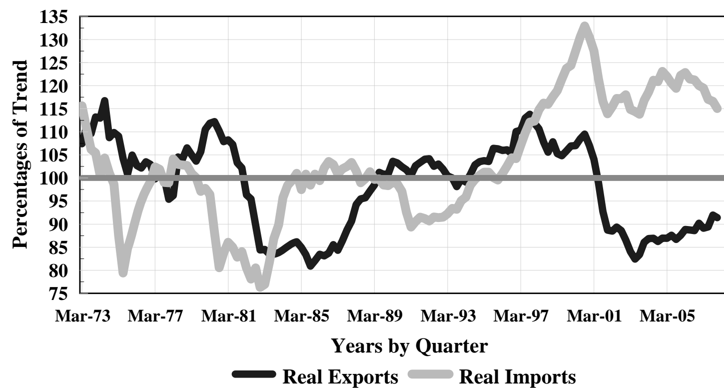
Real Exports and Real Imports as Percentages of Trend



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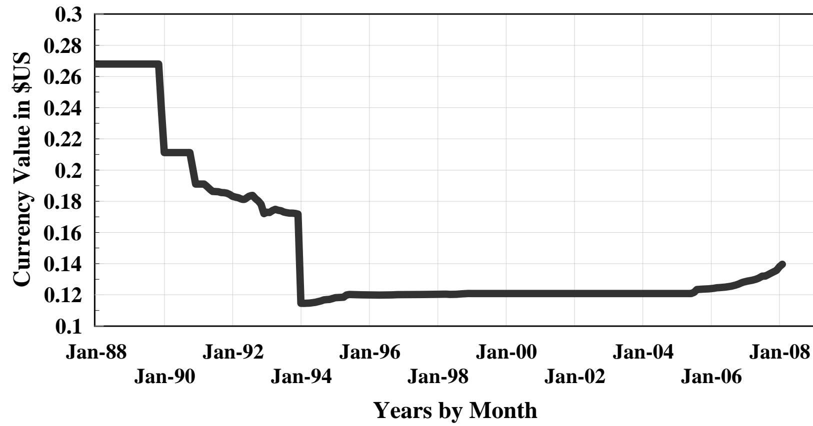
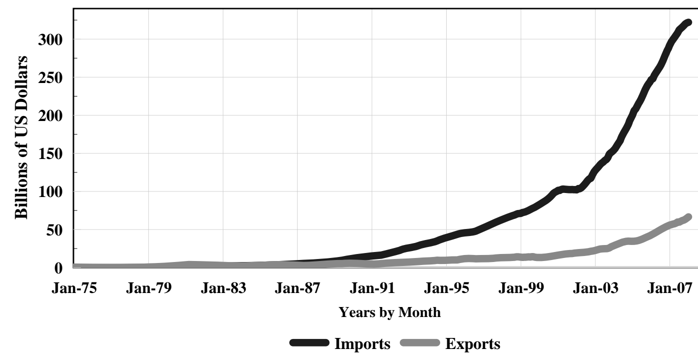
The Value of the Renminbi Yuan in $US

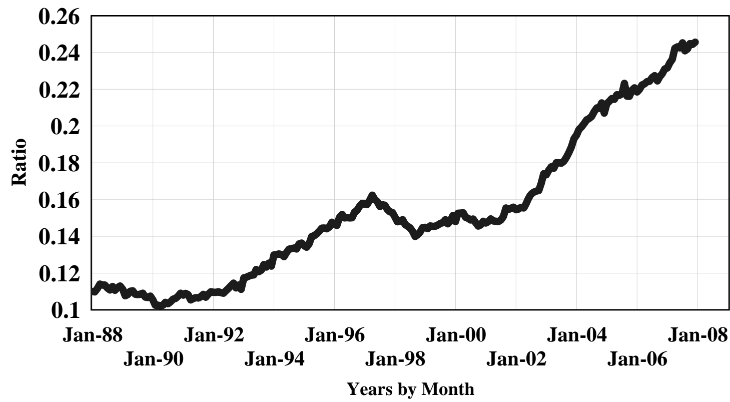


U.S. Trade with China ($US Billions)

Twelve Month Moving Sums of Not Seasonally Adjusted Data



Ratio of Reserve Bank Credit, Total Domestic & Foreign Source, to U.S. Personal Income



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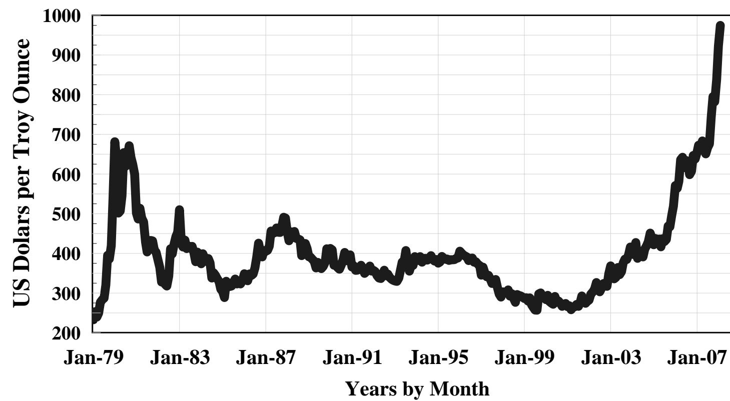
The Price of Gold

US Dollars per Troy Ounce



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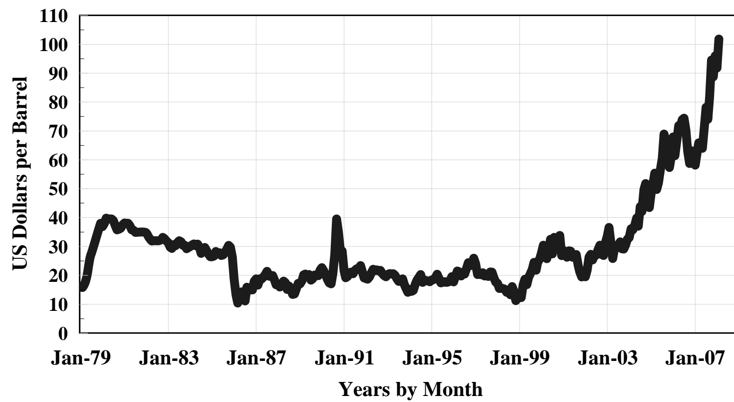
The Price of Crude Oil

US Dollars per Barrel



PPI and CPI Inflation, Consumer Finished Goods

Year to Year Percentage Change