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By John Mauldin

This week we continue to look at the imbalance in global trade and the US trade deficit. What are the ramifications for the dollar? I am going to weave together several different lines of thoughts from analysts all over the world and see if we can see a pattern emerge. While I give a brief synopsis of last week's letter below, for those interested you can read the full letter at www.2000wave.com.

Bretton Woods 2, Redux

As I wrote last week, the first Bretton Woods system came about when representatives of most of the world's leading nations met at Bretton Woods, New Hampshire, in 1944 to create a new international monetary system.

Under the Bretton Woods system, central banks of countries other than the US were given the task of maintaining fixed exchange rates between their currencies and the dollar. They did this by intervening in foreign exchange markets. If a country's currency was too high relative to the dollar, its central bank would sell its currency in exchange for dollars, driving down the value of its currency. Conversely, if the value of a country's money was too low, the country would buy its own currency, thereby driving up the price.

The dollar became the world's reserve currency. Yet there were limits placed upon each country and especially the US. Each country had to police its own reserves and currency or be forced to revalue. And the US was constrained because the dollar was fully convertible into gold. This changed in 1971 when Nixon closed the gold window.

Now we have what many are coming to call a Bretton Woods 2 system. That is where much of the world, but primarily the Asian countries, have more or less informally agreed to peg their currencies to the dollar. They do this in order to maintain their relative competitive ability to sell their products to the world and specifically to the US.

The competitive devaluation game that this has spawned is even more unstable than the original Bretton Woods. Asian countries are now taking US dollars that are going to be worth less at some future point than they are today. As I showed last week, the losses they will experience are not some paper transaction, costless central bank game. These will be real losses of buying power and in some countries can mean significant (I mean quite large in terms of GDP) loss of cash reserves, especially for some of the smaller Asian economies.

At some point, the game will end. But at what point, and when, are the key questions? I quoted a paper by Nouriel Roubini and Brad Setser that suggest the time is close:

"Initially, Garber, Dooley and Folkerts-Landau suggested the new system of fixed and quasi-fixed exchange rates would last a generation, until China's agricultural labor surplus was absorbed in a new urban industrial sector. More recently, Peter Garber backed off a bit, but he still maintained that the new Bretton Woods system would last another eight years. Michael Mussa has suggested it will not last another four years. We believe it may have difficulty lasting for another two years.

"…we [that is, Roubini and Setser] argue that there is a meaningful risk the Bretton Woods 2 system will unravel before the end of 2006."

There are no economic free lunches. There is a trade-off for everything. I prefer the market to make those decisions, but we do not have a free market in currencies. It is manipulated by Asian central banks, and that distortion is going to cause pain down the road.

How can we get an understanding of how and why the system might unravel? I think the best model is to look at game theory. In game theory, the **Nash equilibrium** (named after John Nash) is a kind of optimal strategy for games involving two or more players, whereby the players reach an outcome to mutual advantage. If there is a set of strategies for a game with the property that no player can benefit by changing his strategy while (if) the other players keep their strategies unchanged, then that set of strategies and the corresponding payoffs constitute a Nash equilibrium.

After showing that the international devaluation game and the accumulation of massive amounts of US dollar reserves in Asia is a significant factor in holding down long term US rates, I go on to the following conclusion:

"The interesting exercise for us is to try and understand how all the "players" in the game will act. What kind of odd Nash equilibrium will they settle into? Will they all share some pain so as to lessen the total amount of pain, or will they seek to avoid as much personal pain as possible thereby causing more pain for everyone else? I am not entirely optimistic, given the current level of the "vacuous rhetoric of globalization." But one can always hope. It will take more than a few beautiful minds to work this equilibrium equation out."

The Heavy Lifting of Global Rebalancing

Let's again start with a quote from Stephen Roach (Chief Economist, Morgan Stanley):

"Global rebalancing does not occur spontaneously. It takes adjustments in economic policies and asset prices to spark a meaningful realignment in the mix of global growth. Shifts in currencies and real interest rates are the two major instruments of rebalancing. The ideal prescription for today's lopsided US-centric world would be a combination of dollar weakness and a rise in US real interest rates. However, there is serious risk that the Fed will not execute the full-blown normalization of real interest rates that the US economy requires. If that's the case, then there will be even greater pressure on currency adjustments to correct today's imbalances — a development that could take world financial markets by great surprise."

Next week's Outside the Box (which should come to you Monday evening) will be a report by GaveKal Research on the meaning of the announcement by Korea that they intend to diversify their reserves. The announcement roiled the currency markets and was accompanied by the usual article in the Korea Times blaming hedge funds for the rising Korean won [the ***won*** – with the "o" making the same sound as in bond- is the name of the Korean currency]. Let's take a side trip and look at a few paragraphs from today's Korea Times:

"The local currency market is turning into one of the most popular playgrounds for hedge funds, with the won becoming the main target by the international speculative funds aimed at short-term gains, analysts said.

"Hedge funds are viewed as the main force behind the won's steep gains recently, they said. It is concerned that they will continue to bet on a stronger won, a major negative for the country's economic recovery.

"Hedge funds were one of the main forces behind the 1997-1998 financial crisis. They usually grow on volatile currency markets."

Notice how hedge funds were one of the main forces behind the 97-98 crisis? Not that Asian countries like Thailand, Indonesia and Malaysia borrowed more in dollars than they could ever repay or that massive government fraud and corruption allowed billions to flow into the private hands of friends of the government or that the general incompetence of the government and central banks might have been a problem or that Russia defaulted on its debt. No, the bad guys are investors in the form of hedge funds that recognized that there was an investment opportunity top shorting bad governments.

Back then, hedge funds shorted the local currencies. Now, they are shorting the dollar and buying the Korean won. They are saying that the won is a stronger currency than the dollar. This of course has Korean authorities upset as they want to keep their currency weak while they sell their dollar holdings.

In essence, the Korean government would like to sell all the dollars they intend to sell before the dollar goes down. Ever had a stock go down before you could sell it? The Korean complaint is somewhat like blaming your losses on all the others who sold the stock you wanted to sell before you could get your own sell order in.

The Dollar as the Old Maid

Remember the card game we played as a kid called Old Maid? You can take a standard deck of cards and remove one queen. The dealer then deals out all the cards to the players. The players all look at their cards and discard any pairs they have (a pair is two cards of equal rank, such as two sevens or two kings).

Then the fun begins. At your turn you must offer your cards spread face down to the player to your left. That player selects a card from your hand without seeing it, and adds it to her hand. If it makes a pair in her hand she discards the pair. The player who just took a card then offers her hand to the next player to her left, and so on.

If you get rid of all your cards you are safe - the turn passes to the next player and you take no further part. Eventually all the cards will have been discarded except one queen (the Old Maid) and the holder of this queen loses.

Korea wants to diversify its holding of dollars in its reserves. How does it do this? It sells the dollar and buys Japanese yen or Taiwanese yuan or Thai baht or euros or any of a number of currencies. Now, of course, someone else has those dollars. If other countries also want to diversify, they start selling their dollars and buying other currencies.

The dollar could get traded from Korea to Taiwan to Singapore to Malaysia. Now, as long as these countries want to keep their currencies weak against the dollar, and are willing to take the loss as the dollar drops, this process works just fine. But what happens when two or three or four countries start to diversify out of dollars? Who gets the Old Maid?

Now I don't think the Korean central bank is completely inept. They made the "announcement" because their books would show that is what they are doing in any event. And you can bet they are watching other countries buy the won in an effort to diversify their holdings.

Hedge funds are convenient scapegoats for a process that is going to happen. Korea is acting just like a hedge fund when they start selling dollars which they think are going down and buy baht or yen or euros. Its just that hedge funds are so convenient when governments want to whine and try to avoid people looking at what they are doing.

If they wanted to weaken their currency, they could do what the Japanese do. The Japanese simply print more yen. Or they could do what the Chinese or do – they could fix their currency to the dollar. Of course, this would hurt the Korean consumer and make their imports more expensive.

Not to pick on the Koreans, but this dilemma is facing all of Asia. When do you start the diversification process? How much of a loss do you take? This interesting note came in today from my friend Dennis Gartman in his daily letter:

"Finally, while discussing the US dollar, we thought it interesting to note comments from Mr. Pierre Lassonde, the President of Newmont Mining. Mr. Lassonde has been steadfastly bearish of the US dollar for quite some long while and has been correct, so we give his views some larger credence than we might otherwise give that past performance. He believes strongly that the dollar has much further to fall. With private capital flows insufficient to fund the US' current account deficit, and now with the additional loss of foreign central banks as suggested by the statements much earlier this week by the S. Korean central bank, Mr. Lassonde speaks now of a literal run on the dollar.

"Following S. Korea's 'lead,' he expects countries like Malaysia, Thailand and Singapore 'to be the next defectors... [for] the appetite of foreign central banks for US dollars is starting to wane.' Interestingly, Mr. Lassonde said that Japan and China shall be the last countries to continue to support the dollar, for they have such enormous positions already established that they've no choice but to hold to their present course of action and try to defend their positions. If we had to bet, we'd bet that Malaysia will be next on the list to join S. Korea."

European Sado-Monetarism

But there are other reasons that Japan and China might have to avoid letting their currencies rise. Anatole Kaletsky of GaveKal research writes:

"But a generalised Asian revaluation, led by Japan and China, looks even less likely after this weekend's G7 meeting than it did before. The Japanese have parried criticisms of their currency intervention in three ways. Firstly, they have argued that the Japanese economy is still in a delicate convalescence and has to be supported with the cheapest real exchange-rate Japan has enjoyed for 20 years. Secondly, Japan's private investors are buying dollars and euros so that Japan's efforts to hold down the yen do not show up as official intervention. Finally, the absence of Japanese official intervention and the recent weakness of Japan's economy have deflected attention to China, where the economy is booming and the control of currency markets is undeniable.

"But China has three arguments of its own for avoiding revaluation. Firstly, China's economic figures offer no support to the claim that its currency is undervalued. China's current account surplus this year will be only $20 billion or 2% of GDP, according to Zhou Xiaochuan, the Chinese central bank governor, who spoke alongside Mr Greenspan at last Friday's London conference. This trivial number suggests that China is not a significant factor in global trade imbalances. Secondly, China sees no case for a one-off revaluation. If there is to be a change in regime, it should be a move towards floating rates. But a floating rate requires a market-based banking reform and this is still far from complete.

"Thirdly, a Chinese revaluation would have no perceptible impact on the US trade imbalance because Chinese wages are so far below America's that even a 30% or 50% revaluation of the RMB (Renminbi), would not be enough to send labour intensive industries back to the US. A stronger RMB would be hugely beneficial to Vietnam, Indonesia, Thailand and other poor Asian countries which compete directly with Chinese costs. And it is to help these smaller Asian economies that China may be persuaded to shift its currency one day. But while a Chinese revaluation might justify dancing in the streets of Jakarta or Saigon, it would be as little help to Europe as to the US.

"What, then, could Europe do to protect itself in the face of a narrowing US deficit, especially with both Japan and China refusing to budge from their present currency regimes? The obvious answer would be to stimulate domestic demand by cutting interest rates and taxes. But the sado-monetarism of the ECB rules this out.

"A second-best approach, if Europe refuses to compensate for lower exports to America by stimulating domestic expansion, would be to try to share the burden of adjustment with another part of the world. China and Japan may refuse to oblige, but there is another place where Europe and America could direct attention and political pressure. Asia's middle-income economies - Korea, Taiwan, Malaysia, Hong Kong and Singapore – have total current account surpluses of around $120 billion. On average these surpluses amount to 7% of GDP, ranging from 3% in Korea to 7% in Taiwan, 12% in Malaysia and a staggering 22% in Singapore. These are much bigger surpluses in relation to the size of the national economies than we see in Japan or China. And, unlike Japan, (and Singapore) these are still relatively poor countries, with fairly young populations and large needs for infrastructure and housing. It makes no sense at all for them to be lending large parts of their incomes to the richest country in the world. It would thus be appropriate for these countries' large current account surpluses to be turned into deficits. Moreover, the economic and technological advances in Korea, Taiwan and even Malaysia in recent years, have made these countries direct competitors to American and European exporters."

China is simply not listening to the US or Europe about the value of their currency. They will revalue when they are ready and not one minute before. But expect a lot of pressure on the rest of Asia, from especially Europe and the US, to gradually allow their currencies to rise.

Such a move is inevitable, in my opinion. But I am not as persuaded or as confident as Alan Greenspan. Earlier this month, while speaking at a conference in Europe, he told the audience that a flexible economic system could "facilitate adjustment to a smaller US deficit without significant costs."

Maybe, but I think that Roubini and Setser have more of the sense of the problem when they write:

"If the US does not take policy steps to reduce its need for external financing before it exhausts the world's central banks willingness to keep adding to their dollar reserves – and if the rest of the world does not take steps to reduce its dependence on an unsustainable expansion in US domestic demand to support its own growth -- the risk of a hard landing for the US and global economy will grow. The basic outlines of a hard landing are easy to envision: a sharp fall in the value of the US dollar, a rapid increase in US long-term interest rates and a sharp fall in the price of a range of risk assets including equities and housing. The asset price adjustment would lead to a severe slowdown in the US, and the fall in US imports associated with the US slowdown and the dollar's fall would lead to a global severe economic slowdown, if not an outright recession."

The IMF's Managing Director Rodrigo Rata highlighted the problem last night in a speech to the Foreign Policy Association. It does not sound like he sees "a smaller US deficit without significant costs." Quoting from the speech: "Record levels of debt are now financed by foreign investors and it is highly unlikely that such easy credit will continue to be available to the U.S. on the basis of the existing policy path...There can be little doubt that the pattern of persistent and growing US current account deficits, and the increase in dollar indebtedness that they entail, have contributed to the recent renewed depreciation of the dollar." (Chuck Butler's Pfennig)

Asian countries are going to start to play a new game. Instead of the competitive devaluation of the last decade, it is now a game of Old Maid. They all want to remain competitive, but they do not want to lose money. There is a Nash equilibrium out there, and they will whine and moan and blame hedge funds along the way to finding it.

Frankly, I hope Roubini and Setser are wrong in their prediction that the Bretton Woods 2 accord will collapse within two years. I hope it takes much longer. I want my pain in slow, moderate (dare we say measured?) amounts. There is a recession at the end or maybe even the middle of the process, and we all want it to be as mild as possible. But that is not the way I would bet it unfolds.

That is enough for this week. Next week, we will talk about why I think the trade deficit and currency problems guarantee that US short term and long term interest rates are going to rise much more than most observers think today. There are two ways to reduce the trade deficit. One is to lower the value of the dollar and thus increase the potential for export. The other is to reduce the volume of imports. That is partly done by raising the price of imported products, but it is also done by raising the costs of borrowing.

The world is going to rebalance, one way or another. You do not want to be on the wrong end of that process.

Tampa, a Hedge Fund Idea and Golf

I should point out that this all ties in with my view that we are in a secular bear market for US stocks. The dollar problems will initially be part of the catalyst for the next bear cycle, but at the end things will look so cheap in the US that the cycle will reverse.

You should have an understanding of secular market cycles. One of the better ways (at least the critics think so) of getting a handle on these cycles is to read my book, Bull's Eye Investing. It is even more pertinent now. You can get it at Amazon at www.amazon.com/bullseye.

I love Anatole Kaletsky's description of European monetary policy as sado-monetarism. As he correctly pointed out, the proper way to deal with their problems would be to cut taxes and government spending in "Old Europe," but you are not going to see that. Except in many countries in Europe, you have seen exactly that. One country after another in "New Europe" is going to a rather low flat tax. You watch how that is going to boost their economies over the next decade. I offer this idea freely, and if someone does it, let me know. Someone should start a hedge fund that only invests in the stocks of countries that have a flat tax. You can hedge it by shorting the stocks of countries with high taxes. Now, of course you need to be a good stock picker and know the local markets and all that, but it would certainly offer an excellent starting point.

We are off to Tampa and Orlando tomorrow, for some client meetings and a speech. I am going to swing a golf club for the first time in a long time, although only a wedge and only on a driving range. My back is slowly improving and it is time to see how much progress I am making. The hope is that by the middle of April I can actually play. And since my friend and London partner Niels Jensen of ARP is going to "force" me to go to meetings in Majorca at his vacation home for the weekend, it would be a nice time and place to pick up the sticks again. We'll see.

I am looking forward to be home for the month of March. I am way behind on a number of projects, and my email inbox (and my reading) is stacking up. The goal is to get everything back to "caught up" by the Ides of March.

Your running so fast his shadow is way behind analyst,

John Mauldin