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By John Mauldin

We have been looking at the US trade deficit and the global trade imbalance for the past two weeks. It is currently an unsustainable trend, and thus will stop at some point. The questions are when and how? We will conclude this series today, looking at several ways the trade deficit could come back into line.

First, a very quick review. For those who remember, you can skip to the next heading. (And for those who would like to read the previous letters, you can go to www.2000wave.com and look in the archives.)

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.

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."

In this game, the dollar becomes the "Old Maid," with Asian countries buying each other's currencies with their reserve dollars in an effort to reduce their exposure to the dollar without also causing a rise in their own currency. A tricky Nash equilibrium game indeed.

Why Trade Deficits Matter?

There is a school of thought that trade deficits do not matter in a modern context. They would contend we are measuring the deficit with tools which were adequate in the past, but which now do not take into account the far higher margins in US business and the intellectual capital and wealth we are in fact creating.

It is true that many Asian businesses, especially Chinese businesses, operate on profit margins that are amazingly small. When Apple imports billions of dollars of I-Pods creating a US trade deficit, it also creates and keeps 90% of the profits attached to the I-Pod all along the manufacturing and selling chain. Which is more valuable, Apple or the factories which manufacture the I-Pods? Thus it makes sense, does it not, that money would want to come to the US to buy Apple and other high margin businesses?

Except the vast majority of money coming to the US is not buying Apple, but US treasuries, which are demonstrably low margin and if you are buying with a foreign currency, a depreciating asset.

I can see the point if we were talking about a trade deficit of 2-3% of GDP, but we are now talking about 6% trade deficits on our way to 7%. This is unprecedented in world history. We are absorbing 90% or more of the total world savings. Our deficits are growing faster than world savings. This is an unsustainable trend. Thus it will end.

While I do not subscribe to this view, the margin of profits in Asia, and especially China, is going to come up again in a few paragraphs.

If Only Asia Would Let the Dollar Fall

There is another school of thought that suggests the problem with global imbalances could be solved if the dollar would correct against the Asian currencies. This seems to be the consensus view. If Asia would simply allow the dollar to fall, thus raising prices of their products to us, that would mean we could not buy as much of their "stuff," and our "stuff" would be cheaper on world markets. If we buy less and sell more, then the trade balance improves.

Yet this has not worked so far. Since the peak of the dollar three years ago, exports have indeed risen by 35%, from $55 billion to $71 billion. But imports have risen by 50%, from $86 billion to over $131 billion.

Proponents of this thinking would point out that the trade weighted dollar has not moved that much at all. And specifically, the Asian currencies have hardly budged. Just you wait, when China and Japan allow their currencies to rise, it will make all the difference. When prices rise, we will buy less. It is the law of supply and demand.

I have a problem with this view as well. First, it is not altogether clear that prices will rise all that much in the short-term. The euro has risen 50% in that time, and while there has been some rise in the cost of European imports, most of the hit has been taken by European companies and not US consumers.

Further, Chinese inflation is around 4%. Since they are pegged to the dollar, for all intents and purposes they have outsourced their monetary policy to the Fed and Alan Greenspan. While that policy is still "easy" in the US after 7 rate hikes, it is enormously easy from a Chinese perspective. Inflation should be running at a much higher rate in China. But it isn't. My bet is that all the capital investment in business and infrastructure is also paying off there in increased productivity, which can offset inflation pressures.

Let's say the Chinese do allow the Renminbi to increase by 5-10% in the coming year. Big Deal. Their businesses would absorb some of the cost, just like Europe is doing, and their increasing productivity would absorb even more.

Plus, what does a 10% rise in the cost of labor in China mean to US buyers of products? Almost nothing.

It would take a massive revaluation of the dollar to have some real impact. But be careful what you wish for. You might get it - real price increases in our import costs, which would be inflationary. Since imports are approximately 15% of GDP (and rising, given the price of oil), a modest 10% increase in prices would mean a 1.5% rise in inflation. What if the dollar dropped 30% over a few years? It could get ugly. Yet 30% is well within what many in the mainstream think the dollar would fall if the Renminbi and the yen were allowed to float. That would mean significant inflation pressures.

Yes, I know that is simplistic, but it roughly makes the point, even if the actual equation is vastly more complicated. Rising foreign product prices will eventually translate into the CPI.

This will cause the bond vigilantes, and presumably the Fed, to raise rates to hold down inflation. Rising rates at some point are not good for housing construction or values. That is a prescription for an eventual recession.

It May Take More Than High Rates

There is yet another school of thought, and Stephen Roach is probably its best spokesman. He thinks it will take both a fall in the dollar and a rise in interest rates. A rise in rates will encourage the consumer to save, as well as reduce the amount of money available to spend because of increased borrowing costs.

"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."

"…Given the reduced currency elasticities of exports and imports that have been evident over the past decade — most likely an outgrowth of intensified globalization — my guess is that it would have to take at least another 30-40% drop in the broad dollar to get the job done. Quite simply, that would be an intolerable outcome for the rest of the world. . And that's where real interest rates come into play — as the primary instrument to temper the excesses of US domestic demand growth and the increasingly high import component of that demand."

I agree with Roach that "Ultimately, the import content of the US trade deficit can only be reduced by a compression in the growth of domestic demand." But I am not certain that higher rates alone will be the cause of a compression of domestic demand. They may be the trigger, but to really affect imports, something significant must happen to the American consumer psyche.

Let me be clear about what I think Roach is saying but cannot say directly. He is referring to the "R" word – Recession. Rates that would be high enough to slow (compress) consumer demand must be high enough to raise borrowing costs. They must be high enough to significantly slow down home equity loans for new consumption.

That will mean lower new home construction, a slower real estate market and thus slower increases or even (gasp) a fall in home values, and slower or no increases in consumer spending growth. Reduced home construction and falling ("compression" sounds so much gentler than falling!) consumer spending. In short, a recession.

The mirror of the recession of a few years ago, when housing and consumer spending did not stop their growth, and the brunt of the pain fell on business. During the last recession we had falling rates and massive stimulus.

Far be it from me to quibble with Roach, who is far smarter than I am, but again, I am not certain that this is the complete picture. I think there is more to it than a falling dollar and interest rates.

It is quite easy for the world to lay the blame for the trade deficit at the feet of the profligate US consumer, helpless in his desire for more stuff, spending beyond his means. And on a macro level, when looking at the entire country, that is true. But it is not the whole picture.

The fact is that the US consumer is in pretty good shape on an individual basis, or at least thinks he is. Our national wealth and income are at all time highs. Our ability to service our debt is well within our income. While "savings" are not growing, we are in fact saving in our pensions and homes and stocks, which do not count in the national savings rate. If this were not true, we would not be at all-time highs in wealth and income.

On an individual basis, most Americans think they are OK. While they might want less debt, they believe they have a plan to deal with it. Yes, I understand all the bad data, the anecdotal horror stories of debt, but I am talking about the vast majority of Americans, not the subjects of the stories.

An Unprecedented Stability

Americans have experienced almost 25 years of an unprecedented increase in stability. Yes, even with the bursting of a bubble and two wars, the world for most Americans is far more financially stable than it was for most Americans in 1980.

And not only an increase in stability, but a decrease in volatility. Home prices seem destined to rise. The last two recessions have been the mildest on record. Part of the reason, for good or ill, is that the US is no longer dominated by manufacturing. In the past, recessions meant large lay-offs at manufacturing companies. While that is still the

case today, manufacturing is a smaller part of the economy, and thus the impact of lay-offs is smaller.

The experience of most people is that their job and income is secure during a recession. There are other reasons for this, which Barry Ritholtz will deal with in next week's Outside the Box.

Bottom line, the American consumer is comfortable with taking on more risk than in the past. Thus, he sees real little reason to change his consumer spending habits, or increase his savings.

A 'Mixed Model' Microeconomic Disequilibrium

Now, let's look at a final way of looking at the problems of the trade deficit. It is not the problem of intellectual capital or a too high dollar or a profligate consumer. It is structural. It is systemic in nature, and will need much more than a lower dollar and higher rates to solve it.

This has been my view, but I was sent a report this week by my friends at Absolute Return Partners in London by Woodie Brock, the founder of Strategic Economic Decisions (www.sedinc.com) of Chandler, Arizona, who gives us a good place to begin, as he commented upon Roach's position. He says it quite well:

"A 'Mixed Model' Microeconomic Disequilibrium: The problems underlying today's imbalances run so deep that neither a weaker dollar nor higher rates will solve the problem of the US trade deficit. … The real culprit lies much deeper in the phenomenon of a 'mixed model' disequilibrium.

"Specifically, the US adheres closely to a textbook model of microeconomics in which *all* three factor markets (capital, labor, and product) are deregulated and flexible. Europe possesses a different model that tolerates much more rigidity in product and labor markets than in the US, as has been amply documented in studies by McKinsey and Co., by OECD economists in Paris, and by others. Finally, Japan and China possess a third model that deviates still further from textbook desiderata. It is characterized by extreme mercantilism, disregard for intellectual property rights, lack of transparency, repressed domestic consumption at the expense of investment, and currency market intervention (Japan) and pegging (China).

"Three inconsistent models are thus at work simultaneously. The imbalances (disequilibria) that everyone now complains about are the result of the workings of this "mixed model".

"Perhaps a better way to make this point is to perform the following 'thought experiment': Suppose that, during the past 25 years, *all* major trading partners *had* followed the model of textbook microeconomics. Then few of today's imbalances would or in certain cases could exist."

The US trade deficit could not exist without Asian willingness to buy our debt in a sort of vendor financing scheme. Such a debt could not exist if Asian governments were not willing to take the risk of actual losses on their dollar holdings, as private businesses with a profit motive would not have done so.

In essence, their governments have held down the value of the buying power of their citizens in order to grow the business capacity of their corporate sector. Has it been a good trade so far for them? It would be hard to say it was not for them. But it is not a trade without risks, both to them and to the world.

There are no free economic lunches. When governments mess around with the free market, there are costs. In this case, we have deferred the cost to the future. But it is still there.

Whatever happened to the powerful growth that a European Union was supposed to bring? Germany and France are mired in slow or no growth economies, with massive 10% (or more) unemployment. As Old Europe has taxed (literally) its growth capacity, created a work environment that is non-competitive, and created a socialist state that is increasingly incapable of funding itself, it has choked off consumer spending and economic growth. This will all be compounded by the demographic tsunami about to hit Europe.

Instead of being a growth engine that could, and should, drive the world, Old Europe is simply an ad hoc collection of nations mired in costly bureaucracies. (That will get a few letters.)

Let's return to the conclusion of Brock's analysis:

"Conclusion: In all quarters, there is a failure to understand that what is killing the global system is the cumulative damage over 20 years of the workings of today's mixed model disequilibrium. If we are right in this assessment, then neither a drop in the dollar nor higher real interest rates will cure the problem of today's macro-imbalances. Both Roach and the consensus are thus probably wrong.

"Radical microeconomic policy reform is needed in which all players would realign their models towards that of the textbook microeconomics. There is only one such textbook model – taught around the world in economics courses from Berkeley to the Sorbonne. And the US model better approximates this than do its principal trading partners. Interestingly, it is French economists at the OECD who most strongly argue this point.

"Inevitably, it will be very difficult to push through the kind of politically painful micro-reforms that are needed. Game theoretically, the Nash equilibrium point of the underlying policy-reform-game is the familiar pass-the-buck strategy whereby each nation does little on its own, and urges "the other guys to get their houses in order."

Regrettably, absent needed microeconomic changes, today's imbalances will worsen and the long run denouement will probably be a collapse of the dollar. This will of course precipitate a whole new set of problems.

"For the reasons we have identified, the world is in a mess and we are very concerned about the long-run outcome."

I am not quite so pessimistic as to see a collapse of the dollar, unless by that Brock means a 30% drop. 30% is something we have lived through more than once without significant problems. I also think this will play out over a longer period than most of us would think.

Let's look at one scenario. Remember, all players in this game can see the problems. And all players want to avoid as much pain as possible. This is not some game where China buys a great deal of our debt and then sells it, crashing our markets out of some supposed geo-political conspiracy theory.

For better or worse, they are married to our markets. To be a little rough, but it is a good analogy; they drink the water from our pond. It would not be in their interests to foul it. The problem is to balance global trade without strangling the world economy.

Each major group and nation is going to have to take a little pain willingly, or everyone takes a whole lot more pain collectively. Asia needs to start allowing the dollar to gently fall – can we say measured? That will not be fun, but it is a first step.

The US, MUST begin to balance its federal budget. Fiscal discipline must be the order of the day. This will not be fun, but it will reduce the need for foreign financing and decrease the systemic risk of a dollar collapse.

Europe must free up its markets, encourage internal consumption, lower its structural costs and get a central bank that does not wear black leather and carry whips and chains. Sado-monetarism, indeed.

Whether from rising US rates or simply the end of a cycle, the US will eventually fall into recession. The engine of global growth will sputter, and this time it will be the consumer that is the problem. Whether that is in 2006 or 2007 or even later, it will happen. The business cycle has not been repealed.

You can count on a major stock market decline in the next recession. The average decline is 43% in a recession. Can we say Dow 6,000? That means many boomers, who are only a few years from retirement, are going to be very disappointed, to say the least.

Do you want to see an increase in US savings? Think 5-15 years to retirement and not enough money to retire. The next recession will shatter the confidence for the Boomer generation in the stock market. They will no longer be able to count upon a

rising stock market to enable them to retire at the level to which they had intended to become accustomed. At that point, the long run for them will be tomorrow.

This, along with a potential slump in housing values, will do more to change the American consumer psyche than high rates or rising prices from a lower dollar.

This for me is the trigger for the Muddle Through Economy for the decade which I am forecasting. Oh, I forgot to mention that a consumer recession in the US will not be good for Asia or the world. This also forces Asia to find new sources for sales. They will have to look inward. As will Europe.

I think the chances that we can skate through the trade imbalance with no effect upon the world or the US to be a probability of only 10%. I think the soft depression that Bill Bonner and others see is a 20% chance. Such a dire event will require serious mistakes upon the part of governments, like protectionist legislation and/or monetary profligacy. Of course, Bill has less than no expectation for governments to get anything right, so his view is consistent with a soft depression.

I think there is a 70% chance we Muddle Through. The dollar will drop (which offers some good investment opportunities). It will not be fun, but then we have all been through lots of recessions and such. After all, we did survive the 70's. The US economy will recover, as will the economies of China and Asia.

I am actually quite optimistic about the future, after we meet the challenging times of global rebalancing. I think the boom after that could be even bigger than the last one, but we have to cross the river of balancing world trade first. It will be a difficult crossing.

Home Again, Sort Of, and Hedge Funds

My twin daughters attend Oral Roberts University, and tomorrow I fly with a third daughter to Tulsa to watch Amanda cheer at a tournament basketball game and then turn around and come home the next day to see my fourth daughter come back from Cyprus. But then no travel plans for a month. We will see what conspires against me to pull me from my reverie.

I am instituting some new policies and procedures for my Accredited Investor E-Letter, which we will announce soon. It is a letter on hedge funds and private offerings. In the meantime, if you are an accredited investor ($1,000,000 net worth or more) and would like to get my thoughts, you can go to www.accreditedinvestor.ws and register. Basically, I work with Altegris Investments to be able to offer investors access to a select group of hedge funds, private offerings and commodity funds. The website explains how we work, as well as outlines the risks involved. Feel free to write if you have more questions.

I wish I could make the offer more universal, but the rules do not allow me to do so. I hope that at some point in the future Congress will decide there should not be two classes of investors, but until that time the rules are quite clear. (In this regard, I am the owner and a registered representative of Millennium Wave Securities, LLC, an NASD member firm. See more disclosures on the web site and at the end of this letter.)

It is late, and I am craving sushi and sake, for some reason, so I will hit the send button and say sayonara. Have a great week.

Your sounding more gloomy than he really is analyst,

John Mauldin

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