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By John Mauldin

This week we look at a speech given by Paul McCulley (Managing Director at PIMCO funds) at my recent Accredited Investor Conference in La Jolla. In it he introduces to us the concept of a stable disequilibrium to describe the state of affairs in world monetary matters. It made a great deal of sense to me and I will try and give you the gist of his thought. For the past few weeks I've been thinking about stable disequilibrium's throughout history and throughout the world of today and think the concept offers us an interesting paradigm through which to view the world.

We look at China and Europe, General Motors and Ford and matters both small and great through the prism of a stable disequilibrium. I think it should make for interesting letter, so let's jump right in.

A Stable Disequilibrium

In the past few months I have written at length about what is loosely known as Bretton Woods 2. In order to understand the problems facing the world you must understand Bretton Woods 2. Let's do a quick review.

"Things fall apart; the center cannot hold; mere anarchy is loosed upon the world, the blood-dimmed tide is loosed, and everywhere the ceremony of innocence is drowned." - William Butler Yeats

Yeats was not describing what has come to be called Bretton Woods 2, but it seems apropos to start with that quote. 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. Because the US at the time accounted for over half of the world's manufacturing capacity and held most of the world's gold, the leaders decided to tie world currencies to the dollar, which, in turn, they agreed should be convertible into gold at $35 per ounce.

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. 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, has 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.

But this system is inherently more unstable than the first Bretton Woods. There is no gold conversion constraint upon the reserve currency. The US has few reasons to protect the value of the currency, and many reasons why they should want it to drop. And there is no formal agreement among the nations. Any nation at any time could begin to act unilaterally to change. Russia has specifically said they would start to have a larger euro component to their growing national reserves. Thailand has said the same, and indications are that they are putting actions behind their words.

I have described the instability in terms of a Nash equilibrium. Again, in review: 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. (John Nash, the Nobel laureate in mathematics was featured in the movie "A Beautiful Mind.")

The US is living, many say, on the kindness of strangers. If it were not for the willingness of Chinese and Japanese central banks, along with their smaller Asian counterparts, to finance our trade deficit, we would be in perilous circumstances. If Asian currencies saw the dollar fall by 33%, they stand to lose over $600 billion in buying power due to their massive $1.8 trillion US dollar reserves. That is a massive amount of confidence.

Yet it works both ways. Exports to the US alone accounted for about 12% of China's GDP, and that was up from 9% in 2000. At current growth rates, US imports could be responsible for 20% of China's GDP by 2008. It may be that China is depending upon the kindness of strangers, in this case US consumers. Other Asian countries have similar, if not as dramatic, dependence upon US consumers. And many of them ship materials to China which eventually find their way to the US.

The elephant in the world economic room is the now $660 billion US current account deficit. At least $465 billion of that comes from foreign central banks. It is an odd Nash equilibrium. They take our paper, which they know will one day be worth less than it is today, in order to be able to sell us products which keeps factories growing. How long can the game continue? In the case of China, it may continue until they have established their own internal equilibrium of jobs for the hundreds of millions of peasants moving from the farms looking for a better life.

It is not a matter of things staying the same. The one thing I can be certain of is that things will most definitely not stay the same. This trend is unsustainable, and so therefore it will end. There is in fact no Nash equilibrium into which the world has settled. We are still “playing the game”" and some players may be opting to take advantage of others. The system itself is inherently unstable, as we will see.

And now enters McCulley, stage left, providing another way to look at our “Nash equilibrium” model. Paul looks at it from the other side of the coin, calling it a stable disequilibrium. He readily admits that we do not often use those words together, but it does describe the scenario in which we find ourselves today.

Divorce, Disequilibrium Style

What is a stable disequilibrium? The easiest (and most colorful) way to describe it is “that period of time in a marriage prior to a divorce.” As Paul pointed out, 50% of the people in any given room (except perhaps your local church) understand instinctively what he means.

With the possible exception of some Hollywood figures, everyone enters into a marriage relationship with the full intent of it being stable and long-lasting. Without getting into commentary on the societal problems of divorce (this is an economics e-letter), let’s look at what happens in a marriage prior to the actual divorce.

At first, things go along well. Then, one partner does something that changes the nature of the relationship. Often it is quite subtle, but something in the fabric of the rapport seems to unravel. At first, nobody can put their finger on it. Often the man is totally oblivious. This lack of touch with reality will soon be pointed out. Probably several times. At this point, the counselor enters and with a little work and love things work out.

But sometimes they don't. The outward relationship continues in seeming stability, while the imbalance gets worse and worse. While the participants may not realize it, close outside observers can see that the relationship is headed for the divorce courts. It is just a matter of time.

There are two sides to every story we are told. In divorce there may be three sides: his story, her story, and the real story. More often than not, the participants are good people. But over time their respective agendas seem to change. Quite often they work hard to keep the marriage together, for the sake of the kids, religious beliefs or whatever. But deep in their hearts, they can see things getting worse and recognize that the ultimate break is coming.

I would add, Paul, that a lot of the disequilibrium is caused by a codependent relationship. Rather than deal with the problem upfront, the participants bicker over small issues, while avoiding their real individual problems.

Such marriages can rightly be described as a stable disequilibrium. Not yet in the divorce courts, but not entirely comfortable for the participants and those around them, with tensions mounting and a break-up ever closer.

Bretton Woods 2 is a stable disequilibrium. We have a number of dysfunctional parties, all acting in their own self-interest, participating in a process that must eventually break down. It is a matter of when, not if.

And as if on cue (and from stage right), into my inbox pops this latest missive from Martin Barnes (he has asked me not to use the words frighteningly brilliant to describe him, so I won't) of Bank Credit Analyst, giving me his own description of the problem. Let me give you a small portion of his letter:

The Grim Arithmetic of the US Trade Deficit

* "The escalating U.S. trade deficit has been due more to strong import growth than weak exports. Faster growth in exports alone will not significantly reduce the deficit.

* "The pace of import penetration should slow, but will not reverse given the huge cost advantage of Asian producers relative to those in the U.S.

* "The U.S. trade surplus on services trade peaked in 1996 as a percent of GDP, despite the U.S. comparative advantage in many service sectors. There is scope for services trade to improve, but it will not be enough to offset the deterioration in goods trade.

* "A reduction in the U.S. trade deficit will require a much lower dollar and a retrenchment in domestic demand, events that will be very deflationary for the global economy.

* "An inevitable adjustment will be delayed for as long as Asian central banks are prepared to be the dollar buyers of last resort. When that ends, markets will force a reduction in the U.S. external deficit. That will be traumatic for the U.S. economy and markets, but may not occur for many years.

"The supposedly 'unsustainable' U.S. trade deficit just keeps getting bigger, reaching a record $730 billion annual rate in February.1 Investors have not seemed overly concerned about recent mind-numbingly large deficits, with the dollar's trade-weighted index actually rising between end-December and end-April. Nevertheless, trade trends remain extremely troubling because growing deficits represent a huge drain on growth and will not always be so easy to finance. An adjustment will be required eventually, and it will likely be traumatic for the U.S. and global economies and financial markets.

"Reducing the U.S. trade imbalance will require a combination of increased U.S. competitiveness, and a marked slowdown in the growth of U.S. demand relative to that overseas. A weaker dollar alone cannot do all the work and there is negligible chance that foreign activity will accelerate by enough to have a major impact. This leaves the unpleasant conclusion that a retrenchment in U.S. growth must play an important role.

"If the financial markets had been allowed to operate freely in the past few years, they would have already forced a major reduction in global trade imbalances. However, massive Asian official purchases of dollars have interfered with the normal market mechanism. In the absence of these purchases, the dollar and the stock market would have been lower, U.S. interest rates higher and domestic demand weaker. A new equilibrium would have been established with the deficit shrinking to a level that private investors would have been willing to finance. This would have been hugely deflationary for the global economy and explains why Asian central banks acted as they did. Nevertheless, although the subversion of market forces has been good for U.S. and global growth, the cost has been ever-larger imbalances and a more difficult adjustment down the road."

"… the escalating U.S. trade deficit has largely been a by-product of the massively reflationary policies in the U.S., underwritten in recent years by the actions of Asian central banks. Thus, reversing the imbalances is likely to be a deflationary and highly destabilizing event for the global economy.

"A retrenchment by U.S. consumers will rob the world of the major source of demand, and a weaker dollar will put downward pressure on profits and prices in Europe and Asia. Thus, while the U.S. receives widespread criticism from global leaders about its trade deficit, this represents a classic example of being careful what you wish for.

"There are many imbalances and excesses in the U.S. and global economy and all are interlinked to some degree….While a benign outcome is possible, it is not the most likely."

(The above paragraphs need to be read with the understanding that Martin is basically an optimist. I highly recommend the Bank Credit Analyst for investors and institutions interested in a balanced and thoughtful (notice I did not say frighteningly brilliant) analysis of the world economic scene. You can go to www.bcaresearch.com to find out more.)

Let's go back to 1970. The United States was in a major confrontation in Vietnam. The Cold War was at its height, and America's military spending was creating problems and deficits as far as the eye could see. France was grumbling about the power of the United States (some things never change), and especially the dollar's role as the world reserve currency. "It's our dollar," said John Connally (another former governor of Texas, but then Secretary of the Treasury), "but it's your problem."

Charles de Gaulle decided that he wanted to trade his dollars for the gold in Fort Knox, and Richard Nixon decided it was time to renege on Bretton Woods 1. A year or so later the oil-producing countries got together and formed an organization called OPEC and raised oil prices. Inflation began to creep up. Commodity prices began to rise. Interest rates started going up. Wages were not keeping up with inflation. The stock market drifted sideways and then wrenched violently down. It was certainly a Muddle Through Decade that caused some severe adjustments throughout the world. (Sound altogether too familiar?)

But prior to all that we were living in what we can now understand as a stable disequilibrium. And that brings me to Paul's second point: the breakdown of Bretton Woods 1 ushered in a period of significant adjustments, which took almost a decade to unwind. Should we expect anything less from a breakdown of the stable disequilibrium of Bretton Woods 2? If anything, the imbalances of today are even more pronounced.

The answer is: not if we are being realistic. It is just one more reason that I believe we will see a return of the Muddle Through Economy which will last for a decade or longer. "History does not repeat," said Mark Twain, "but it does rhyme. The 10 years following the breakdown of Bretton Woods 2 will not look exactly like the 70s, but it will be a period of significant instability for, and the mass rearrangement of, whole segments of the worldwide economy.

In the 60s and 70s, the Western world saw the Soviet Union as a powerful foe. Ronald Reagan and Margaret Thatcher saw the Soviet Union as a stable disequilibrium, and worked to bring about its collapse in divorce. The point is that a lot of things that we take for granted as stable may ultimately be seen to be unstable. A trend that cannot continue, even a trend that we like, is by definition a stable disequilibrium.

European pension and health commitments are a stable disequilibrium. Likewise, the pension and health benefits of General Motors are a stable disequilibrium.

Sidebar: I find it interesting that that old corporate raider, Kirk Kerkorian, is now on the prowl for General Motors. At first glance it seems like this 87 year-old gentleman has finally lost his marbles. The company is by definition a stable disequilibrium. When the divorce begins between the shareholders, bondholders, unions and retirees, it will make a Donald Trump divorce look like child's play.

However, I don't think I would bet against Kerkorian just yet. He's got all the money that he could possibly spend, but there's a lot more than money riding on this deal. If he can somehow pull something out of the fire that is General Motors, it will be a deal for the ages. It will get him more than a few footnotes in history, and that is the only thing he doesn't have now. I'm not privy to his personal counsel, but I think I see a rhyme in his actions. Basically, General Motors is an auto and mortgage finance company that builds cars as a hobby. A hobby, I should point out, that loses a lot of money.

If you could get rid of that money-losing hobby along with the pension and health care commitments, General Motors is actually worth quite a lot of money. Substantially more than Kerkorian is now paying. Watch for him to start agitating for General Motors to spin off their finance divisions. Then watch for the car division to file bankruptcy. Those shareholders get screwed, but they more than make up for it with the profits on the financial subsidiaries. The pension and health benefits get renegotiated and General Motors survives.

Perhaps more benignly Kerkorian may suggest that the board simply give the auto manufacturing portion of the Company to the unions. Kerkorian takes some of the debt in exchange for the finance operations, throws in a few incentive clauses here and there, and voila! Kerkorian walks away with another billion or so, along with a few footnotes. And now back to our regular story.

Is There No End of Instability?

I look at Europe and I see a stable disequilibrium. Slow growth in the West, major demographic problems, France looking like it will vote no, significant cost of labor disparities between the East and West, an unsustainable health care and pension system, massive bureaucracy, a proposed constitution that no one has read and no one is sure what it actually means, not to mention multiple languages, old animosities and an increasingly uncomfortable electorate.

Perhaps with a great deal of counseling, and a lot of give and take on the partners, the marriage of Europe can be saved. Perhaps a no vote here and there will force them to get realistic and propose something that could actually work. A little reality therapy. I hope so. A strong and united Europe is a major plus for the world.

I should point out that there was a lot of give and take when the United States was initially formed. It took us many years after we won our independence to actually have a functioning nation. It was not altogether clear or certain that the United States would actually emerge from the disparate interests of the various states, let alone survive. That it did was a blessing to the world. I think that in 50 years we will see that a united Europe, if one should come about, will also make the world a better and more stable place. While Europe's problems are daunting today, necessity (and the marketplace) will force them to solve the problems in one fashion or another.

The Breakdown of Bretton Woods 2

What could be the trigger that would signal the end of Bretton Woods 2? A US recession is the obvious answer, but problems in Asia or an unwillingness on their part to finance our trade deficit are also just as likely.

Over the past few days I've had a number of e-mails suggesting that China is getting ready to revalue its currency within the next few weeks or even days. Of course I get an equal number of e-mails suggesting that there's no way in Hades that China is going to do it this year. Let's leave aside the issue of when for a moment, and speculate upon what revaluation might look like and how it might affect the US.

I think it is unlikely in the extreme that China simply wakes up one day and decides to float its currency. It is far more likely that they allow for a wider trading band around the current price. Credible sources suggest that that might be a 5% number. If that works okay, then they would expand it slowly over time. It won't be enough to make certain numbskull US senators happy, but that's another story.

But let's assume for the moment that they allow the Renminbi (RMB) to adjust by 10%. Would that help the US trade deficit? The simple answer is probably not. In fact, it might make it worse. It would allow China to buy oil and other imports at a price that is 10% cheaper than it is today. The cost of labor to build the products it exports would only rise by 10% in terms of foreign currency. If labor is making a dollar an hour, what's another dime?

In fact, the rise in labor might be offset by a decrease in other costs. A 10% drop in the RMB by itself would do little to help the US trade deficit. In fact a 20% or 30% drop in the RMB by itself would not have that much of an effect. Now, if every Asian currency dropped by 30%, along with that of our other trade partners, that would begin to eat into the buying power of the US consumer. It would also create instability within the US. That means consumers, and especially boomers will become more uncomfortable, which presumably would lead them to save more and buy less. That would reduce the trade deficit. Be careful for what you wish.

If China could reduce the cost of its imports by 10%, and not lose much of its market share in the United States, why does it not go ahead and just revalue? Because China is its own stable disequilibrium.

While it has not made the news in the United States, there is a rise in the number, intensity and size of demonstrations in China. China has 20 million people, moving from the country to the cities every year. They must build the equivalent of a Dallas, Texas every month and a half. They have to find jobs, housing, services and infrastructure in a staggeringly short time. To fail to meet those expectations will create problems and more tensions.

Chinese banks are worse than bankrupt. The government banks have been making massive loans to insolvent and unprofitable state businesses for decades. They continue to do so because to allow them to fail would create massive unemployment. Massive unemployment would create unrest in the cities and surrounding areas. Above all it would disappoint the rising expectations of a growing Chinese middle class. That would create more tension.

While the government of China has done an impressive job in managing the largest migration in the history of the world (some 200 million people have moved the country to the cities in the last 20 years), it has not been without cost. There is an increasingly unwieldy top-down bureaucracy trying to keep things going along, while a freewheeling market economy is emerging. Freewheeling economies and top-down bureaucracies are not a prescription for stability.

Further, it is not altogether clear that allowing the RMB to float will mean an immediate rise in the value of the RMB. We have seen massive foreign direct investments in China for the last 20 years. That investment has not had a chance to leave the country. Do you think that investors might like to take a little off the table when they get a chance?

I watch with increasing interest as a growing number of Chinese entrepreneurs come to the United States capital markets and list their companies on American exchanges through reverse mergers. Do you think they might like to diversify their newfound wealth? Do you think other Chinese entrepreneurs would also like to diversify?

While I think over time we will see the RMB rise significantly, if the Chinese were allow the RMB to float today, it is not altogether clear to me that the initial move of capital would be into China. A radical readjustment of the currency in a country that is not prepared for it, and is already rife with potential instability, simply doesn't make sense.

What does make sense is for China to slowly and steadily allow the RMB to trade with increasingly wider bands, and to let their entrepreneurs and businesses adjust to the new realities. And we in the United States should not wish for anything else. One of the absolute worst things that could happen for global stability is for China to become internally unstable. While in the grand scheme of things this process does not have to take a long time, it is certainly not going to happen in 6 or 12 months.

We are in for a long and difficult period as the world hits the reset button, as Bretton Woods 2 collapses and as a new world balance emerges. The worst thing that could happen is for this process to happen in too short a time period. That is a prescription for worldwide depression. No, we need our pain in small measured doses. It took a long time to get in the current stable disequilibrium. It has been fed by codependent relationship among all parties.

In an odd way, the United States is probably better positioned than all the other parties to come through the Muddle Through Decade. Our entrepreneurs and businessmen are used to having to adjust to changing times. Our free market system is more resilient than the mercantilist systems of Asia or the bureaucratic socialist systems of Europe.

That doesn't mean it will be a picnic or that it will be particularly enjoyable. It does mean that with proper planning, investors and businessmen will be able to maintain and even grow their portfolios and businesses. And proper planning means that you have to understand that McCulley is right. We are in a stable disequilibrium. It is going to end in divorce. It will be a period of creative destruction. There will be plenty of opportunities, but not for those that insist on trying to do business, or trying to invest, in the old ways.

Napa Valley and Chicago

I will be going to Napa Valley for a small private gathering hosted by Rob Arnott and Research Affiliates. He has assembled quite a group of investment industry "players" to come together to ponder "The Stealth Bubble." Financial services now representing 30+% of Russell 1000 profits for 2004, and 20+% of market capitalization, book values, dividends and revenues for the economy, though it still represents less than 10% of the employment in the economy. Forty years ago, financial services comprised less than 5% on all of these metrics. In our industry, we sell risk management, risk reallocation, transaction facilitation, comfort and hope. Question: is this a normal evolution in a more services-oriented economy, or is it abnormal for an industry that produces nothing tangible to be one-fourth of the economy? I will take notes and report back.

It also looks like I will be in Chicago around June 7 for some meetings, and may have some time to meet with clients and prospective clients. And for those interested, I did pass the English Securities exam. They did not tell me what my score was. They only have three results: pass, fail and almost passed. I am not certain how knowing you almost passed is supposed to help. I guess its like British humor – you're not quite sure but everyone around you is laughing their heads off. One-third of those who took the test failed, although they did not say how many "almost passed."

I mentioned at the beginning of this letter the Accredited Investor Conference we held last week. It is a conference that we are forced to limit attendance to because of US regulatory requirements as we not only have speakers like Paul McCulley, Richard Russell and Rob Arnott, but we also talk about hedge funds and private offerings. We will do one again next year.

If you would like to know more, you can go to www.accreditedinvestor.ws and sign up for my free letters and reports on private offerings and hedge funds. You must be an accredited investor (basically $1,000,000 net worth or more, see the web sites for details). I have just written a new letter which will go out to current subscribers early next week. Basically, in conjunction with my friends at Altegris Investments (and my European partners Absolute Return Partners) we offer information and research on and access to hedge funds and private offerings. You can read the web site for details on how it works.

(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.)

Time to go. My #2 daughter is waiting patiently for Dad to come and have a late dinner. And the Rangers are getting beaten badly (7 run first inning for Cleveland), so I think I will beat the crowd and leave. Enjoy your Mother's Day!

Your thinking about change analyst,

John Mauldin