By John Mauldin

This week we take a look at the dollar and global trade imbalances. I will use the draft chapter from my book-in-progress on the topic.

I need to thank so many of you for your book title suggestions. We have had almost 1,000 proposed titles come in over the last two weeks. Some of you put in a great deal of thought, did cover designs and detailed analysis. I wish I could write each one of you personally, but I need to keep writing on the book. I want to finish this month.

Let's go straight to the book.

King Dollar and the Guillotine

"Whoever you are, I have always depended on the kindness of strangers."
(Blanche Dubois from Tennessee Williams' *A Streetcar Named Desire.)*

The world is in the midst of a major transformation of the global economy. This realignment will mean that a number of trends that have been in place for many years are going to be reversed. These changes have the potential to be quite painful for persons and businesses involved, not only in the US but those abroad as well.

We will look at several individual pieces of the global economic puzzle and then see if we can put them together to give us a true picture of what we face as the decade evolves.

The Kindness of Strangers

The US is "borrowing" roughly $500 billion per year from foreign nations. Our economic growth has been predicated on this borrowing. Of course, the growth of the world economy has been based upon the US expansion. It has been a virtuous circle which is about to reverse into a vicious cycle. The following quote from the ever-insightful Stephen Roach gives us a starting point:

"A saving-short US economy has had to import surplus saving from abroad, mainly from Asia but also from Europe, in order to support economic growth. And the US has had to run a massive balance-of-payments deficit in order to attract that capital. As America's federal budget now goes deeper into deficit, the country's net national saving rate -- for consumers, businesses, and the government sector combined -- could easily plunge from a record low of 1.3% in late 2002 toward "zero." In that case, the US current-account deficit could approach 7% of GDP, requiring about $3 billion of foreign financing every business day. The world has never before faced an external financing burden of that magnitude." (Stephen Roach of Morgan Stanley)

After hitting record lows in the spring of 1995, the broad trade-weighted dollar surged some 47% through early 2002. The broad dollar then began to drop, losing about 8% through April. Against the euro (and certain related currencies), the dollar has dropped 30% from its high. The euro started at $1.14 in January of 1999 and then fell to only $.82 before rising back to $1.15 in early May. Will the dollar drop further? Let's explore what led to the rise of the dollar, and then see how vulnerable it is to further decline.

The Artificial Dollar

The dollar is artificially high. By artificial, I mean the following things: first, the rest of the world, and especially Asia, is hooked on selling products to the American consumer. If prices were to rise 30%, we would buy less of their products and more of our own. If they sell less, their unemployment rises and profits drop.

For now, they are willing to take dollars because it keeps their factories going. They convert those dollars into local currency or other currencies.

Secondly, there are those who hold dollars because it is better than their local currency. Physical dollars are desired in many Latin American and African countries, and other parts of the developing world. The clear pattern is that the dollar is a better value than the local currencies.

(Could the euro become as popular a currency as the dollar? Sure, but then there would be two choices, not an abandonment of the dollar. Will it be more popular than the dollar? In some countries, yes, especially those closer to the Eurozone. But the primary driver for such holdings is not to get the best performing currency, the euro or the dollar, but to have a currency which is not their local currency, which their local governments continually inflate and debase.)

Third, it should be obvious that if we were not the reserve currency for the world, the dollar would not be as high. The dollar would have less buying power. Foreigners look at that buying power and are often jealous, seeing it as part of so-called American hegemony.

But it cuts both ways. An artificially strong dollar has meant that our manufacturing base has slowly been eroding as more and more jobs leave the US for cheaper production climates. It has created an imbalance in our trading accounts and buying patterns. There is no free lunch.

If the dollar is artificially high, is there reason to believe it can drop? A Federal Reserve study seems to indicate there is. Fed economist Caroline Freund did a study on what happens when the trade deficit gets too big in developed countries.[1]

Here are the highlights: On average, when the trade deficit widens to over 5% of a nation's GDP, the currency starts to drop. It typically drops 20% over three years, as the trade balance recovers. (The study also shows GDP growth slows down by about 3% from the year prior to the current account peaking, and short term rates rise. We will deal with those inconvenient elements in later chapters.)

Thus, at 6% and approaching 7% of GDP trade deficits, the US is in No Man's Land. There is real precedent for the dollar to continue to fall, IF the artificial props are removed. Again, those props are the desire to sell to the American consumer, the need for a store of value in developing countries as opposed to the local currency and the fact that the dollar is the reserve currency for the world. Let's see how likely it is that these could change.

Why the Dollar Rose

At the same time as the dollar was rising, the US and particularly US consumers were increasingly becoming the engine of growth for the world. The United States accounted for fully 64% of the cumulative increase in world GDP (at market exchange rates) over the 1995 to 2001 interval -- double its share in the world economy. By way of comparison, over the eight-year period, 1995 to 2002, Euroland real GDP growth has averaged just 2.2%. Such anemic growth accounted for only 9.6% of the average growth in world GDP over that interval, far short of the region's 15.7% share of world output (as measured on a purchasing-power parity basis). (Morgan Stanley)

There was a massive drive, particularly from Asia, to sell anything and everything to the US. Indeed, much of the "Asian Miracle" was the result of increased sales to the US. The appetite for dollars was huge. The central banks of the world took those dollars and placed them in their electronic vaults as reserves.

In mid-2003, the world continues to buy our goods, stocks, bonds, businesses and real estate to finance our buying binge. On balance, the US owes $2 trillion dollars to foreigners, net of our investments overseas. That number has been growing dramatically for the last few years.

(As an aside, as the dollar drops, it make our foreign assets worth more in terms of dollars and those dollar assets held by foreigners worth less [in terms of their local currencies]. Thus the drop of the dollar actually improves our statistical national balance sheet, in a perverse sort of way.)

The economists at Morgan Stanley estimate that the trade deficit could be almost 6% of GDP in 2003, which would be 50% higher than ever seen. We would need over $2

[1] To read the study you can go to http://www.federalreserve.gov/pubs/ifdp/2000/692/ifdp692.pdf.

billion per day from foreign sources, which could grow to $3 billion, as Roach estimated above. This is unsustainable. Just as Amazon.com could not grow their stock to the sky by borrowing and spending far more than they could make, the US will one day have to pay the piper.

If the projected 2004 rate were to continue for an extended period of time, foreigners would own everything not nailed down in the US in a few decades, which clearly cannot happen. Something will have to give, and that something is either the value of the dollar or a massive reversion in US dollar outflows, or a combination of both. We will need to export more and buy less on a huge scale for this to happen. One of the natural market driven ways this happens is for the value of the dollar to drop. It makes it more expensive to buy foreign goods (therefore we buy less) and it makes our goods cheaper for foreigners to buy (therefore they buy more).

Those who are not worried about the trade deficit and the dollar point out that foreigners have a seemingly bottomless appetite for dollars, and that as long as the dollar and the US remain as the safe haven of choice, there is little reason for alarm. But when you look into the recent trends of the actual sources from where we get those foreign investors buying dollars, it is easier to be concerned.

When we buy foreign goods, we convert dollars into the currency of the country where the product (or service) is made. When a foreigner wants to buy something in the US, he must get dollars. An imbalance in the flow of currencies is what makes the value of currencies go up or down. It is supply and demand in its rawest form. If more people want dollars, then the dollar goes up.

But how can the dollar be going up when we are spending so much more than we are selling? It is because foreigners are taking those dollars and buying US companies, property and US stocks and bonds. Also, foreign central banks, especially Asian central banks, use the dollar as a reserve currency.

One of the largest sources of dollars during the rise was from foreign companies buying US companies or setting up production facilities in the US. In the period 1990-95 average annual European dollar flows from mergers and acquisitions (M&A) was only $10 billion. In 2000, Europeans bought over $600 billion of goods, services and investments in the US. Direct investment was a whopping $237 billion and purchase of securities other than US bonds was $327 billion. Taking away US investments in Europe it was a net $194 BILLION to the advantage of the US. That process alone financed half of the trade deficit.[2]

In 2001 the positive balance from Europe was $184 billion. That process began to dramatically slow down in 2002, as the positive balance was only $3.5 billion. As we will see below, in 2003, the direction is clearly the other way.

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[2] You can see the source for these stats and a mountain of other data at the US Department of Commerce's Bureau of Economic Analysis web site at www.bea.doc.gov .

But Europe was not the only source for a rising dollar. Asia has been a significant source for dollar power. As an example, Asia increased its dollar holdings substantially in 2001. "Net US inflows from Asia (excluding Japan) totaled $17.3 billion in November and another $19.8 billion in December, the strongest two-month surge on record. In December alone, the region accounted for 42% of total US inflows, with China and Hong Kong the primary sources of capital. **The late-year surge in inflows from Asia ex-Japan pushed the regional total to a record $111 billion for the year, more than double the level of the prior year.**" (Morgan Stanley)

Unlike Europe, Asian buying of dollars has continued through 2002 and 2003. There is a considerable time lag in the data on foreign purchases, but in just the month of February, 2003, there was large net Treasury buying from Japan ($5.58bn) and China ($1.80bn).

(However, the Euro area took out (-$3.4bn), the UK (-$2.9bn) and Canada (-$1.9bn). [Source: Marshall Auerback of the Prudent Bear Fund] Not surprisingly, the countries that are selling are seeing a significant loss on their dollar investments in terms of their currencies.)

Now, let's look at one of the reasons why Asia is buying dollars.

The Competitive Devaluation Raceway

One of my favorite analysts is Greg Weldon. One of Greg's main themes is "The Asian Competitive Devaluation Raceway." By that, he means that Asian countries keep lowering the value of their currency against each other vis-a-vis the dollar, so as to be more attractive to the US consumer. Each country is worried that if their currency gets too strong, that the other Asian currencies will have an advantage.

How do you lower your currency? You create more currency than is demanded or is needed. You buy dollars with that currency for your central bank reserves, and invest them in US government bonds.

This race has been going on for years, with one country after another pulling into the lead. It seems no country has been willing to let their currency get significantly stronger than their "competitor" countries.

That is not good for their consumers, of course. That means US products and services cost a lot more, and hurts our exporting businesses. It is not good for their lifestyles or savings.

Then why do they work so hard to keep their currencies low against the dollar? To keep their exports up, which is what they believe will eventually bring prosperity. Each nation feels that if their currency goes too high, it will give the other nations an advantage over them of selling products to the United States.

As just one example of many possibilities, the head of the Thailand central bank gave a short speech last year about his country's problems. Weldon noted he used the word "export" five times in only a few sentences, or 12% of his whole speech. He was clearly worried, as Thai exports were down 8% at the time of the speech. The head of the bank was focused on exchange rates, and especially the way that the Japanese yen has dropped much lower than the Thai baht.

Of course, the Japanese have publicly argued for several years the yen is too high, and work aggressively to lower the value of the yen, even as it rises. A few Japanese leaders have publicly stated the yen should be at 160, not the 116 it is today (in mid-May). Other Japanese leaders would clearly prefer the yen to be at 130. (As a side note, it is instructive when a central bank has trouble debasing its currency, even when its stated policy is to do so. Usually, the one thing a central bank can do is destroy its currency. The Japanese central bank even fails at that.)

Now, here is the heart of the matter: if each of those Asian countries thought they could all get a stronger currency against the dollar, they would be for it in a heartbeat. It is not that they want a strong dollar, they just don't want their currency to be stronger than the other Asian currencies. If the dollar were to show weakness against all the Asian currencies at the same time, they would not object. They would be thrilled.

The 900 pound gorilla in this process is China. The Chinese currency is pegged at a fixed rate to the dollar, so there has been no movement. Since China has a very pronounced advantage over other Asian countries in regards to labor costs, these other countries feel forced to keep their currencies low in order to compete. The Japanese have been particularly vocal in their complaints about the value of the Chinese currency.

Countries which sell to the US, especially Asian countries, have a choice of two potential sources of pain. They can either let their currency rise and sell less to America or they can take dollars which will have real downside risk.

When does the pain of taking over-valued dollars become more than the pain of selling less to the US? I think it is when China allows their currency to float. Asian countries do not necessarily want an over-priced dollar; they simply want the price of their currency to be favorable in relation to their neighbors, and when the Chinese allow the renminbi to rise, that will be the real end of the dollar being over-valued as the rest of Asia will feel comfortable in letting their currencies rise as well.

There is an increasing call from many corners of the world for the Chinese to allow the renminbi to float. They have not responded to the pressure, but as do all countries they will act when they feel it is in their own best interests. That will probably be when they think their own consumer demand is growing and solid, and thus can sustain a possible slowing of sales to the US. When that will be is anyone's guess, so the dollar could be somewhat strong for a period of time even when by other measures it should drop.

China will be the surprise move which sets this set of dominoes in motion. This is one area which investors must watch closely, as it will be a surprise and will be the transition to a much lower dollar fairly quickly.

Addressing another point, you will remember I noted above that the dollar is down about 8% on a trade weighted basis, but is down over 30% against the euro. What is holding the value of the dollar up?

Quite simply, Canada, Mexico, China and Japan account for 47% of the trade weighted currencies. The Canuck and yen are only slightly up, the peso is down and the Chinese currency is pegged to the dollar, so there has been very little movement from a major part of our trading partners. This will change, of course, but it is one thing holding up the dollar. Thus the drop in the euro (and euro related currencies) is the single major reason the dollar has dropped slightly on a trade weighted basis, when seen on a multi-decade chart. (Source: A. Gary Shilling's INSIGHT newsletter)

By the way, the dollar dropping 20-30% is not the end of the world, as some would have you think. The dollar dropped by over 1/3 against all currencies in the 80's and early 90's, and the US seemed to move along just fine. Inflation dropped during that time and the economy grew. A falling dollar will help our exports, of course. I expect the Bush administration to continue to tacitly approve a weak dollar policy while continuing to say the market should determine prices.

An Uncomfortable Adjustment

In 2002, Morgan Stanley projected that a 20% drop in the dollar against the euro would knock 1% off of the GDP of Europe and it looks like has done just that. Such a drop hurts their sales to us and makes their goods and services more expensive to the rest of the world. If the dollar were to drop another 10-20% and the euro go to $1.25-$1.40 (as seems quite possible) you will hear screams and moans throughout Europe, as business would have to compete against much cheaper production from not only Asia but from the US. Germany in particular is vulnerable.

A rise of that magnitude would mean the price of products made in Europe would have risen 50-70% in terms of dollars over a period of just a few years. This will give the US (and Asia until China revalues their currency and the rest go along) a huge advantage in selling products and services to Europe and a major competitive advantage in the rest of the world. If European businesses are already having problems (and the statistics suggest they are) then this would be even more devastating.

What could Europe do? They could ask for an increase in tariffs, but this would start a trade war which they would lose, and could possibly trigger a world-wide recession. It would also contravene a lot of treaties they have worked very hard to get signed, and also cause a major split within the European Union. This is not a likely scenario.

The more likely effort will be intense lobbying to get the Chinese to allow their currency to float against the dollar.

But it does mean Europe will face significant economic difficulty. It could also lead to the very real problem of deflation.

The Artificial Dollar and Deflation

As we will see in the next chapters, there is a global wave of deflation washing over the countries of the world. One of the not so subtle hints from members of the Fed, who are concerned about deflation in the US, is that allowing the dollar to fall will provide significant help in the fight against deflation.

One of the side effects of the competitive currency devaluation was that Japan and China in effective directly exported their deflation to us. Now, Europe is in the same situation. It is quite possible they could see deflation within the next year or so. One of the disadvantages the European Monetary Union has is that its response to economic problems are limited by agreement, so that in extraordinary circumstances the European central bank simply does not have solutions available to them

As noted above, one of the potential outcomes is that China revalues their currency and the rest of Asia goes along. That would be good for Europe. The world moves to balance its books. There are winners and losers, but that is the way things have been since the Medes were trading with the Persians. The countries that can best cope with change will be the winners.

Except. Except the Japanese get hurt in the process. They are clearly fighting serious deflation, and a rise in the value of their currency would be deflationary. They are starting to paint themselves into a corner. While we will deal with Japan in a more in-depth way next chapter, an example here will illustrate the point.

The Japanese have debt problems which quite simply dwarf those of the US. "Consider the notion that, with perhaps $11 trillion in savings, the Japanese have enough wealth to cope. It sounds as if they do--until you realize that the total on- and off-balance-sheet claims on the household, corporate and government sectors in Japan are about $30 trillion, according to estimates by Goldman Sachs. That sum is six times Japan's $5 trillion GDP. (The total of U.S. public and private debt is $19 trillion, two times GDP.) Their banks are bleeding and are in a true crisis. The four largest banks are reporting losses approaching $3 trillion yen, or over 20 billion dollars. Analysis of Japanese business is bleak, and consumer demand there is decreasing as the population ages rapidly." (Forbes)

The level of bad debts at Japanese banks is staggering. Many outside analysts believe Japanese banks are essentially bankrupt. Their accounting rules would make Enron executives blush. AS an example, they do not mark to market the stocks on their books.

Japan is the third largest economy in the world. They have been a major source of lending in the world, and a weak Japan is good for no one. Can Japan afford to let its currency rise 20-30%? Can it keep it from happening without massive printing?

If Japan will not let its currency rise, can the other Asian countries? For instance, if the Korean won rose 20% against the yen that would make a Hyundai cost the same as a Toyota. The price advantage goes away, and Korea suffers. The variations to the currency dance are wide.

Can You Focus the Picture, Please?

Let's look at the puzzles pieces:

1. The dollar went to bubble-like artificial heights because the world wanted to sell products to America.
2. American consumption was abetted by ever lower interest rates which allowed consumers to borrow money, especially on their homes, and by a stock market bubble which made people feel wealthy. Both of these trends are over.
3. There has never been a case in the history of the world that when trade deficits rose to the heights we are now at that a serious currency correction did not soon follow.
4. Such corrections typically slow down the economies of all concerned
5. The world, and especially Asia, is focused on selling products to the American consumer. The US was responsible for 65% of the growth in world GDP.
6. This can't continue forever, so at some point the rest of the world must find additional consumers to sell products their products to. But the major sources of potential customers are in weak positions. Many of the developing countries have little real internal consumer spending.
7. Many world economies are already weak. Japan is in depression and Europe will likely be in recession by the end of 2003, if not before. Bright spot economies like China depend upon ever increasing world trade for their growth.

Thus, this means that the developing nations, which have focused on selling to the US, will have to develop their own internal markets. We will have to transition from a US-centric world where all roads lead to the US consumer to a more balanced world.

By "have to" I am not referring to some moral imperative whereby the US gladly allows the value of the US dollar to drop, thus making the costs of the products we buy more expensive, but I mean "have to" in the free market sense. The world simply does not have the choice. There is a limit to everything, even the kindness of strangers.

Until the rest of the world and especially Asia can wean themselves from dependence upon the American consumer, the dollar will remain artificially high. That is not to say it will not continue its decline. It will. It is just that it will take longer than it would without the artificial factors cited above.

The adjustments among world currency and trade patterns will take years, and will be painful in some circles. It will not happen all at once. The US will not go from a huge trade deficit to a positive balance within a year. It will take many years. Foreign sellers will sell wherever they can make a profit and will continue to sell to the US, just at higher prices. While the US will not be the only engine for world growth in the future, it will still be a major trading partner. It is not like the US goes away. It is just that we buy less "stuff."

But the adjustments will act as a drag on many of the world markets, perhaps putting the world into a synchronous recession. Such a recession will have the effect of helping the world re-balance its trade priorities, which will mean a much more stable period of growth following this period of transition.

How will it all play out in detail? What will be the value of the dollar? How will world trade be affected? There is simply no way to know. There are too many variables to make any realistic prediction.

What we can say is that there is a high degree of likelihood that the dollar will be lower by at least 20-30% (across the board, with some currencies much higher and some much lower), that the world will find customers in addition to the US, and that this will cause a major shift in buying patterns within the US.

Swiss Banks and Texas Hospitality

I am finishing up a little earlier today as a friend (Constantin Felder) from Safra Bank in Geneva is in town helping me understand the many changes (plus a lot of opportunities) that are happening in Swiss and international banking. It was quite interesting to discuss the material above with someone who has a much different perspective than we in the US have.

Of course, I get to introduce him to Texas barbecue and Southwestern cuisine. I think Texas barbecue is a good trade for a little information.

Can my Dallas Mavericks take the king? Like trading stocks, it all depends on who's hot.

Your sitting on the floor under the basket analyst,

John Mauldin