Bastille Day on the Foreign Exchanges? Hardly!

The U.S. current account deficit is running at unprecedented levels, a condition that many analysts fear is unsustainable. In their view, the U.S. recovery, such as it has been, is already mortgaged to historically low, nominal interest rate and they worry that foreigners could suddenly develop an unwillingness to finance the deficit **at current interest rates**. Will foreign owners of dollar assets now storm the Bastille? In a world in which interest rates are at historically low levels, this seems to be a strange worry, unless the critics mean that the Fed would not be able to intervene and hold short rates at "pre-reluctance" levels. Is this something about which investors really need to worry?

Further worries concerning the sustainability of any recovery appear to emanate from concerns over the insufficiency of U.S. savings (government plus private sector savings). From a macro point of view, insufficient savings (government plus private sector) is equivalent to an excess of expenditure over output---in effect, another form of the current account "dilemma" noted above. Does the U.S. have two problems or is this a two-faced Janus, the same issue in another guise?

If the U.S. imports too much and exports too little, equilibrium for the world as a whole as well as the U.S. requires a massive change of exchange rates between the dollar and other currencies. In terms of the ancient language of the absorption approach to the balance of payments, a current account deficit is a reflection of expenditures exceeding domestic output. In order for 'macro balance' to be achieved, expenditures must fall while at the same time, the composition of domestic output must shift through the expansion of exports and import substitutes while consumption declines through the reduction in imports. The needed **compositional** change in U.S. spending as well as the **reduction** in spending will produce the required increase in national savings necessary for U.S. macro equilibrium. Since the U.S. economy is operating well below its potential growth, spending reductions are not a desirable route to equilibrium. In fact, it is clear that reducing the U.S. current account deficit by export expansion and perhaps import contraction reconciles external and internal equilibrium because it expands aggregate demand. The real issue is how the U.S. can affect dollar devaluation and over what time period is such devaluation likely to occur?

In the longest of long runs, an exchange rate between two currencies should reflect the relative price of a similar bundle of goods produced locally or produced 'abroad.' (Purchasing Power of Parity). PPP is very much a theoretical and long run criterion, but the real world is a succession of short runs often interrupted by poor economic policies. Even if the cost of a Big Mac, adjusted for the exchange rate, is never equalized across the world, the path toward equalization is important because the "path" influences asset holders' expectations. Consequently, asset holders' expectations are a legitimate concern of policy-makers. Could expectations of foreign holders of U.S. securities be sufficiently fragile that a herd reaction to convert their dollar holdings would create a macro problem for the U.S? In principle, yes, but practically, there is a policy barrier here, ironically one imposed by foreign central banks.

On the policy side, the U.S. has no direct tool to effect a real devaluation of the dollar. For the U.S. to experience real devaluation, the world trading system, ex-U.S., has to revalue its collective currencies. As a practical matter, it is the exchange rates between large surplus countries (areas) and the U.S. that really matter. If those prices can change, the U.S. current account deficit can begin to reverse. Other than through exchange rates, the only other remedy is that the rest of the world would begin to grow much, much faster than the U.S. Something to dream about, but not something that is likely to occur.

Narrowing our focus to the key U.S. trading partners, this means that both Asia (including Japan, NJA and China) and Europe will have to experience sharp revaluations. Presently, the EURO has changed (albeit insufficiently) while Japanese policy makers have tried to offset any market tendency for the Japanese Yen to appreciate. Behind the scene, the RMB (the Chinese Yuan) and China's growing payments surpluses would seem to indicate an RMB revaluation would be highly useful.[1]

From an economic welfare point of view, one might think that revaluation would be in the interest of these countries because revaluation means cheaper foreign goods to consume. In fact, however, internal politics have dictated economic policies in these countries that lead away from equilibrium exchange rates. Neither "pole" appears willing to permit the U.S. to reach equilibrium through a massive, dollar devaluation (revaluation of their own currencies).

This has created the paradox that these "export driven" countries have become the (reluctant?) financiers of American excess consumption. There is a strange historical parallel for this set of circumstances in the events that led up to the U.S. closing the Gold Window and abandoning the Gold Exchange Standard in 1971. At the time, the U.S. was also running a substantial current account deficit and fighting a foreign war (Viet Nam). Relations with France were troubled at that time as well, and the French began to exercise their discontent with U.S. policy by converting excess dollar balances into gold. That action stimulated a rush from the dollar by private holders. Ultimately, the foreign demand for gold led the U.S. to abandon gold and float the dollar. Going from a gold exchange standard to a fiat currency standard did not give the French what they wanted (neither a change in foreign policy or less inflation) because massive dollar devaluation must mean a retrenchment of exports to the U.S. by foreign countries. In fact, it made holders of dollar assets into hostages.

The dollar still "floats;" the U.S. is running a larger current account deficit and again, the U.S. is involved in a military campaign in a foreign country. The modern "fear" that one day we will be forced into a massive restriction of consumption to 'pay off the foreigner' has returned. In former days, when the Treasury issued U.S. Notes, there was the inscription, "Pay the Bearer on Demand." Dollar Worrywarts fear a long line of bearer's who wish to sell their holdings of U.S. assets (principally) Treasury Bills and Treasury Bonds. The prospect of a rising yield curve while the U.S. economy works through a recovery seems as if it could be troublesome.

Until the second week of June this year, this fear was an abstraction because the fear of deflation was the driver that had brought down the middle and long end of the yield curve. Suddenly, a reversal began, slightly before the FOMC last met on June 26. Long bond yields started to rise. Herd mentality suggests that when the first trickle of fear hit bondholders, the highly levered carry trade sought to bail. A similar sentiment affected JGB's and the Japanese yield curve also steepened sharply. Is this the beginning of the end? Is Herb Stein's famous dictum, "If something cannot go on forever, it will stop" now in play?

One intriguing question is why the rest of the world keeps providing the seemingly unlimited finance for the U.S. 'binge?" As long as the rest of the world 'finances' the deficit, U.S. residents will likely continue to consume beyond their 'means.' (This is the 'insufficient savings' argument). As for U.S. policy options, the question is whether the Fed or the Treasury has a weapon in its arsenal to force U.S. trading partners to make these currency changes? Or, are we sailing on a doomed ship because these trends are not sustainable and no 'relief' is likely to be forthcoming from the export-driven economies?

Talleyrand once said that the trouble with the Bourbons (referring to Royal House before the French Revolution) was that they had "learned nothing and forgot nothing." Something of that sort may apply here. Countries with large surpluses need to think about this. Consider the fundamental question of whether there is

[1] We will deal with this issue and the paradox of the RMB in a later Ecomentary.

any limit to the capacity of the rest of the world to hold U.S. dollar assets? In a world dominated by private holders of foreign government securities, the issues are two-fold: **political risk and potential exchange rate loss**. The latter illustrates the fundamental economic problem of modeling an exchange rate crisis. When investors and speculators 'think' the game is over, it frequently is---or their actions force it to be over and faster than can be imagined. If this were purely a private market issue, such as speculators taking on the foreign exchange holdings of a non-reserve currency country, the canonical currency crisis models would be relevant. That ***obiter dictum*** may not apply to the U.S. dollar---particularly if the U.S. really has no control over the exchange rates of its major trading partners. A herd-like conversion by foreigners of their U.S. government bond holdings would be an uncomfortable circumstance for monetary authorities abroad. Rising interest rates in the context of insufficient growth in demand could be initially discomforting, but it is highly likely that the Fed would respond to rising rates with a much more aggressive quantitative easing. In the present context, that could only be a positive, until such time that the U.S. is growing at or above its potential growth rate.

If the U.S. were in the midst of a long slump, trying to rekindle sufficient economic growth to reduce the slack in the labor market, then the Fed would be obliged to buy sufficient government paper to prevent the yield curve from moving upwards. Sooner or later, the expansion of high-powered money implicit in this scenario will have an effect on output and only then on prices. That would bring the 'deflationary episode' to an end.

Note, however, that massive sales by foreigners of U.S. government securities would also entail pressure on their own central banks as the dollars received were exchanged back into local currencies. If not offset by central bank operations (sterilization), these currencies must rise (revalue). Therein lies the rub, the effort by foreign countries that have export led demand growth as the centerpiece of their stabilization efforts. They typically look to resist such pressures to revalue their own currencies. Japan is an obvious example.

Why do major countries or regions try to fight such revaluation pressures? To do so, in the EU or China or Japan is equivalent to exchanging real goods and services (exports) for promises to pay by the U.S. government. By any reasonable welfare standard that is a poor choice. Yet, many foreign countries find it impossible to restructure their own absorption because it would involve reducing their exports and increasing their imports. Why? If revaluation is good for consumers, it must be difficult for producers. Since politics nearly always trumps economics, their cycles of export dependency are continued without relief. Consider Japan.

Japan has been running an export surplus longer than any modern portfolio manager can remember. As a result, it is accumulating claims on deficit countries and the largest claim is on the U.S. In modern day parlance, the seignorage that arises from the dollar as an international reserve country allows U.S. residents (and government) to spend more than they take in by issuing cheap-to-print paper in exchange. It is politics that allows this to happen. It is hard to imagine any Japanese administration that would preach a reduction of exports. It is even more difficult to imagine a Japanese administration that would vocally favor drying up the (non-competitive) import competing industries in favor of more imports. Any politician going down that road would wind up in political oblivion even if the restructuring of the Japanese economy that would result would be a net benefit. In the short run, labor in exporting and import competing industries would have to be transferred to the domestic goods and services sector (strictly speaking, the non-traded goods sector). That would entail a great deal of voter opposition. The losers in Japan would be producers, large companies and family enterprises that exist by virtue of an overvalued exchange rate. When a country has a social ethic that says unemployment is far worse than poor labor and capital allocation, changes are fought zealously. It is a simple matter of who wins and who loses. That is why Japan fights hard against a revaluation of the yen. What about

China? Same thing, different language.[2] Economists often cite the implicit (welfare) costs to a program of import substitution—but there is symmetry here. Export promotion can be welfare defeating!

The obvious answer to the world's macro disequilibrium is for the surplus countries to promote domestic aggregate demand expansion, which in the nature of the case would probably mean aggressive tax reduction to stimulate domestic consumption and domestic investment. For several of these countries, that would be a desirable structural change. Unfortunately, the political economy of many surplus countries positions the government as a principal provider of many goods and services that could otherwise be produced via the private market. To tax less must mean a decline in government spending as a percentage of national spending. If the politicians and bureaucrats in such countries are unwilling to endorse the punishment of valuable voter constituencies served by artificially undervalued exchange rates, how much less willing are they to cut off their own noses in shrinking the size of government? The answer is clear. Political dynamics dictate a very long period of adjustment for the U.S. dollar---maybe longer than the market could ever discount?

The situation in the EU is nearly parallel. Clearly, the EU is operating below its potential output, or to put it another way, national spending is clearly lower than potential output. Theory suggests that demand expansion should come through tax cuts, but in the context of the Growth and Stability Pact that should mean less government. Tax cuts but no expenditure cuts are the more likely outcome. Again, the "iron triangle," of exporters, import-substitute producers and government itself will not promote an efficient solution.[3]

The macro-economic disequilibrium that pervades the world economy contains a strange irony. The U.S. spends more than it produces (or if you prefer, has insufficient savings). The rest of the world runs an export surplus with the U.S. and is forced therefore to export capital to the U.S. The capital assets 'acquired' are claims on U.S. private and public issuers. Were this a private market situation, excessive debt issuance would first begin to create higher debt costs and ultimately a fear of default risk. But, this is not a private market context at all. That is why the dollar is strong. Part of its strength comes from the political and economic power of the U.S. and **part of it comes from the faulted policies of its large trading partners!**

To assert that the U.S. is about to face a sudden, violent withdrawal of confidence by foreigners and a striking unwillingness to hold dollar denominated assets is tantamount to asserting that the central banks of these same countries are going to allow their currencies to revalue upwards. Should this be a realistic fear for policy makers in the U.S? Not at all! How likely is the political economy of export-driven economies to suddenly change, placing the interests of their consumers and taxpayers above that of their laborer-firm owners? In our view, not very likely! We have them by the dollar.[4]

The last time a foreign country tried to force the U.S. to change its domestic-cum-foreign policy was Degaulle

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[2] The Chinese case may differ slightly because the undervalued RMB appears to promote rapid foreign direct investment, which is highly desired by China. The dynamics of an RMB revaluation on FDI flows will be treated at a later date and we mention them now only because strictly speaking, they ought not to be left out.

[3] Tax cuts without government expenditure cuts will provoke a reaction from the Central Bank. The similarity between the reaction of the ECB and the BOJ is not an accident. Central Bankers deeply worry when the fiscal authority begins to travel on the road of permanent deficits. In Japan, it brought about a fight for control of Japanese finances and similar overtones can be seen in the EU. In our view, Greenspan's initial railing against the Bush tax plan was not an accident. It was totally consistent with conventional Central Bank preferences.

[4] That is a true "strong dollar" policy.

in 1971. He succeeded in pushing the U.S. off the Gold-Exchange Standard and forcing the world onto a true dollar standard. A fiat based dollar standard deprives the holders of any leverage whatsoever.

Tallyrand's dictum has a very wide application, not merely confined to the Bourbons. Some countries learn nothing and forget nothing! Ball in your Court, Gentlemen! Let the Games continue!

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