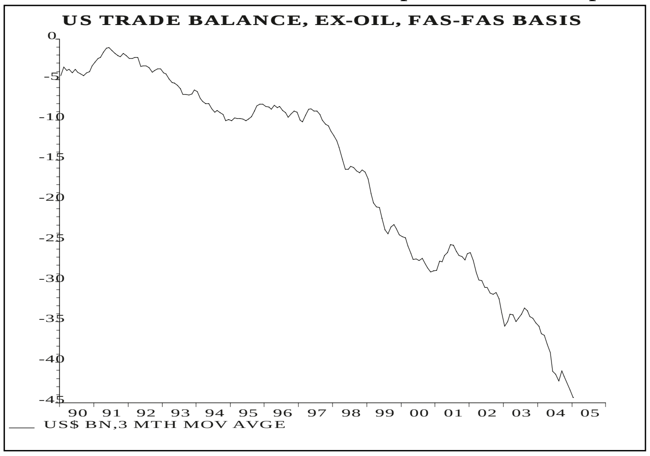
March 14th 2005

GFC ECONOMICS

DAILY COMMENTARY

US DOLLAR CRISIS LOOMS

Another poor set of US trade numbers has sent the US$ tumbling, bond yields up, and stocks down. Voracious demand for consumer goods pushed the non-oil trade deficit up to record levels in January. Unsurprisingly, the trade-weighted US$ had slipped to new bear market lows on the broad Federal Reserve measure by the end of last week. The risks of a swift move in the euro up towards the US$1.45-1.50 area in the coming months are self-evident. But it is hard not to see the yen being dragged higher by cross-the-board selling, which has already sent the US$ down to new lows against other Asian currencies. The short-term inflation risks of a current account deficit heading for 7.0% of GDP this year are mounting. Rising import prices, higher goods inflation and the continuing climb in raw material costs will inevitably force the Fed to keep tightening. Eventually, that will slow the housing market, which in turn should help to stabilise the external deficit. But the lags involved are potentially very long and quite precarious. The trade numbers are likely to get a whole lot worse before that point arrives, particularly given the obduracy of Chinese officials. In the meantime, the risks of a complete loss of confidence in US assets must be high. Parallels with 1987 are being invoked, and for good reason. Ten-year Treasuries could spike well above 5.0%, sending stock markets down significantly over the summer.



Trade Deterioration Continues

It is unusual for the bond market to move so far on the back of one month's trade numbers. But that is a sign of the times. The key inflation risk facing the US economy is not a pick-up in the labour market, slowing productivity growth or strong ecnomic activity *per se*. Instead, it is an unrelenting rise in the external deficit and the threat of a major sell-off in the US$. The US authorities might reasonably ponder whether the rising trade deficit is their fault, when domestic demand in Europe and Japan remains so sluggish, and the Chinese stubbornly refuse to revalue or float their currency. It certainly seems a little unfair to blame the US trade deficit on fiscal profligacy when Japan, the UK and much of Euroland are running similar budget deficits - even larger in some cases.

But in another sense, the record trade shortfalls are a direct consequence of the very Keynesian US monetary policy Mr Greenspan has pursued since the mid-1990s. Faced with the possibility in December 1996 that investors might be suffering "from irrational exuberance", the Fed Chairman chose not to intervene in asset markets. While he had doubts over the trajectory of share prices, he preferred to let dotcom mania run its course, raising interest rates only when the ensuing economic boom had pushed the unemployment rate down to 'inflation' threatening levels. The core position of the FOMC was very Keynesian. When asked, with the benefit of hindsight, whether he would have tightened and prevented the stock market bubble taking hold in the late-1920s, Mr Keynes suggested not. It might, he argued, still prove better for the long run performance of the economy, to let asset inflation run its natural course, and then worry about the consequences afterwards. If policy is tightened too soon during an economic upswing, we may never discover how far any surge in capital spending will raise the potential growth path of the economy. It was the policy response in the aftermath that was crucial, making sure enough was done to support a recovery in demand when the bubble did burst.

Unwittingly or not, Mr Greenspan and the US administration have followed this advice to the letter. At times, the policy has been very successful. As we have argued on many occasions, the

GFC Economics
Coborn House, 3 Coborn Road, London E3 2DA
Tel. 020 8981 8085 Fax. 0870 056 1693
graham.turner@gfceconomics.com - rupert.thompson@gfceconomics.com - ben.combes@gfceconomics.com

US has benefited considerably from the boom in capital spending. In all probability, the potential growth path of the economy could well be running above 4.0%. As a result, domestically generated price pressures remain well contained, as shown by the fall in core service sector inflation during 2004. But in place of the dotcom bubble, the US is now in the throes of a housing boom. That matters on two levels. For one, the build-up in corporate sector debt witnessed in the late 1990s has been replaced by an unhealthy rise in personal sector borrowing. The private sector debt to GDP ratio is now higher than in the spring of 2000 when dotcom mania came to an end. Attempts to reflate out of one bubble have simply spawned an even bigger debt problem. As a result, the long-term risks of debt deflation have risen.

Secondly, the housing boom has indirectly helped push the trade deficit up to record highs. And in this critical sense, US monetary policy is facing its most difficult challenge for a decade or more. Rates will have to go higher. If they do not, the market response to a current account deficit heading for 7.0% of GDP - a much steeper yield curve - could be more disruptive and destabilising. The FOMC have to slow the housing market, and by extension, consumer demand. Otherwise, the loss of confidence in US assets will be more acute.

After Friday's trade report, there is certainly a case for suggesting the Fed might accelerate the pace of tightening. The headline deficit was held down by a fall in oil prices, which of course, have since risen sharply. The non-oil FAS-FAS trade deficit climbed to US$46.0bn in January, and was comfortably above the previous record of US$44.3bn set two months earlier. Much of this deterioration came in consumer goods, where the monthly deficit rose to a new high of US$25.4bn. The steady rise in the trade shortfall on capital goods, food and industrial supplies showed no sign of abating either. The US has traditionally run significant surpluses in the first two of these areas. But the latest figures confirm the US is now a significant net importer of capital goods and food, to the sum of US$14.0bn and US$6.4bn respectively during the year to January. The rising shortfall on industrial supplies is no less worrying in light of the recent acceleration in non-energy commodity prices. From this perspective, the refusal of the Chinese authorities to countenance any revaluation of its currency carries a significant threat for the US economy. Rising raw material costs are not only feeding through to higher import prices and pushing goods inflation up, but it is also wreaking havoc with the US trade numbers. The deficit on industrial supplies was a record US$215.2bn in the year to January.

But that is still dwarfed by the deficit on consumer goods, which hit US$273.8bn over the corresponding period. And to cap it all, there has been a significant deterioration in the 'real trade' balance of late. The growth differential between export and import volumes has widened sharply. It is perhaps worth remembering that in 1987, the real numbers were improving for much of the year, and yet the US$ still went down. The real adjustment was effectively swamped by the terms of trade, or J-curve effect. We have not even got close to the point where the volume numbers are starting to respond. Partly, that is because the US$ has not fallen anywhere near enough. But the very same forces that have kept US inflation comparatively low have also prevented the usual terms of trade adjustment from correcting the trade imbalance. Both of these considerations suggest we are still in the early stages of what could potentially be a very protracted US$ crisis. The fallout for Treasuries could be quite debilitating.