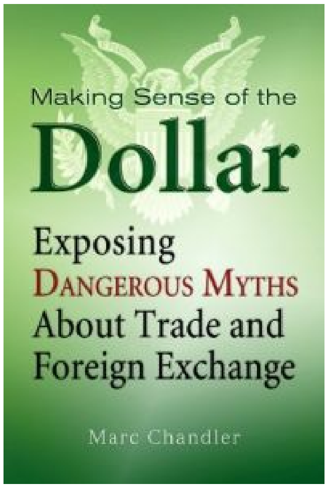

Book Making Sense of the Dollar

Exposing Dangerous Myths about Trade and Foreign Exchange

Marc Chandler
Bloomberg Press, 2009
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Recommendation

Marc Chandler is one of the most widely respected, prolific pundits on currency markets and foreign exchange. In this book for lay readers, he summarizes “dangerous myths” about currency markets and foreign exchange. The myths are dangerous because they can lead to the kinds of mistakes in public opinion that generate disastrous political and economic policymaking. *BooksInShort* recommends this accessible book and finds that Chandler does an excellent job of summarizing and countering some of the most wrongheaded, naïve or confusing blunders, blinders and bewilderments that vex discourse about the dollar, the trade deficit and the economic strengths of nations.

Take-Aways

- Financial myths lead people to believe incorrect ideas about the dollar.
- For instance, contrary to fiscal myth, trade deficits or surpluses do not signal national economic strength.
- Current methods of calculating trade deficits are outmoded and mistaken.
- Labor productivity, not market flexibility, is the backbone of U.S. economic power.
- Though some view capitalism as monolithic, it actually manifests in many varieties.
- In fact, America is as much socialist – or as Peter Drucker said, “postcapitalist” – as it is capitalist.
- The dollar is and is likely to remain the world’s most important currency.
- Globalization has helped make America stronger and more productive.
- Dollar weakness does not help American exports.
- While not particularly mysterious, currency markets are not suitable for individual, retail investors.

Summary

“Myth 1: The Trade Deficit Reflects U.S. Competitiveness”

Antiquated accounting methods distort the picture of the United States’s international competitiveness. When a U.S. company sends parts abroad for assembly and then brings back a finished product, trade accounts record the transaction. Because the finished product has a higher value than the parts exported, the U.S. trade deficit grows. However, the entire transaction has taken place within a single company. Does such accounting make sense?

> “The system of trade accounting, no longer offers an accurate picture of how the global political economy works. It is based on a world that no longer

exists."

Trade accounting ignores much of the value that an American export creates. For instance, the trade value of services is notoriously hard to calculate. Europeans who vacation in the U.S. consume tourism services, but trade accounts do not reflect such transactions. Balance of payment accounts also do a poor job of measuring the value added by technology, specialized skill and management ability. Antiquated accounting fails to measure the right things and leads to misconceptions about what policymakers should do. The trade deficit is not a problem that needs to be corrected; the problem that needs correcting is the way trade is measured. International trade does not put American people out of work. Technology – made in America – has changed the way people work, improving productivity so much that fewer people can do more. Restrictive trade policies won't change that.

"Myth 2: The Current Account Deficit Drives the Dollar"

The Bretton Woods system, which was based on the dollar and the value of gold, governed international monetary affairs from 1944 to 1972. However, the system proved unsustainable. With the advent of floating exchange rates in the 1970s, market transactions came to determine the value of currencies. It is true that when the dollar "weakens," or becomes less expensive, U.S. exports also become relatively less costly compared to other countries' products. However, this does not mean the U.S. is better off. A weak dollar means it is more expensive for Americans to buy foreign materials than producing those materials may cost.

> "Despite the near-constant wailing of the alarmist claims, there is no evidence that central banks as a whole have reduced their holdings by a single dollar through the middle of 2008."

The current account deficit measures the flow of trade, but not the flow of capital. Here, again, an inadequate metric can lead to muddy thinking about problems, policies, solutions and opportunities. To understand economic conditions, you must also consider the capital account. For one thing, dollar weakness can discourage investment in the U.S. because investors, including domestic corporations, may prefer to put assets where currencies are gaining value, not losing it. Investment flows have as much – or more – to do with the value of the dollar as trade flows.

"Myth 3: You Can't Have Too Much Money"

The current account does not measure U.S. trade and competitiveness accurately. Because the current account position is identical to investment minus savings, its distortions call for a closer look at the question of American savings and the idea that having ample capital is always a good thing. The flip side of the alleged American savings shortfall is capital surplus. When an economy holds too many savings, problems ensue. Businesses overinvest and overproduce. Banks may make too many bad loans, because capital is cheap and profitable opportunities are scarce. The result of having too much money is deflation and economic distress.

> "The activities of multinational corporations are tracked using an accounting system designed for a world where only some nations could do sophisticated manufacturing."

Capital must be able to move freely in search of opportunities. Efficient capital markets facilitate this flow and are, therefore, critically important. For this purpose, the U.S. has the world's best capital markets. Innovative financial technology has created new financial products and investment opportunities, while information technology makes it possible for U.S. investors to monitor investment in a Chinese company as easily as they might track a stock on the S&P 500.

> "Amazingly, the movement of goods and services within the same company accounts for half the U.S. trade deficit."

American savings are larger than current tracking methods reveal. Investments by U.S. workers in defined-contribution pension plans make up a large portion of U.S. savings, but the statisticians and accountants who track national savings ignore the amount that these assets appreciate as long as pension plans hold them. The system measures money deducted from a paycheck and invested in a 401(k) tax-deferred retirement account based on its value on the date of investment. It measures money withdrawn after retirement at its value on withdrawal. Yet, while the investment stays in the plan and hopefully grows no national metric tracks its change in value.

> "The trade balance is no longer a valid scorecard for America's global sales and competitiveness."

Technological progress also gives U.S. corporations more value for their capital investment costs. For example, because computers, trucks and air conditioners all have improved, companies that replace older models get much more functionality, often at a lower price.

"Myth 4: Labor Market Flexibility Is the Key to U.S. Economic Prowess"

Many academic commentators have praised American labor market flexibility as the reason for U.S. economic strength. Ironically, many of them are professors with guaranteed tenure. Most Americans experience labor market flexibility as a terrifying threat, manifested through downsizing, firing, and other slings and arrows of economic life. Labor market flexibility allows companies to hire and fire at will, and workers to come and go as they please. Well, it may allow workers to go as they please – or it may force them out. This, in fact, is a problem. Capital is mobile and can cross the globe instantly in search of a profitable opportunity. Labor, however, is not mobile.

> "Globalization means a great deal more than outsourcing. Trade has become 'in-sourced'."

Actually, much of international trade occurs within corporate boundaries. For example, a German steelmaker is building plants in Brazil, Mexico and the state of Alabama. The Brazilian plant will produce steel slabs with Brazilian iron ore. The Mexican factories will make stainless steel, while the plants in Alabama will make steel for autos and other products that require high quality. Intrafirm trade does not behave like trade among unrelated parties. For example, currency shifts probably won't change the relationship between a European car company and its U.S. subsidiary. Such a trade does not require third-party financial institutions. And, shifts in the relative value of currencies merely mean that the company is putting more money in one pocket than in another.

> "The basic determinants of the value of money are supply and demand, the same as for any product or commodity."

Since labor does not move as easily as capital, workers in Alabama, Brazil and Mexico clearly benefit from policies that allow the German steelmaker to move capital to their regions and employ their people. The ease with which entrepreneurs can open and close businesses relates to national economic strength, in that the easier opening and closing a business is, the likelier entrepreneurs are to take risks and, in turn, create jobs. Yet, overall, work is easier to move than people. Fortunately, sophisticated supply chain technology and efficient capital markets can bring work to people. The U.S. challenge is not to prevent low-skilled work from going to places where low-skill labor is cheap and abundant, but rather to ensure that U.S. workers have the opportunity and incentive to improve their skills so they can compete for the most demanding, remunerative work.

"Myth 5: There Is One Type of Capitalism"

Former "socialist" countries, such as Brazil, Russia, India and China, have adopted "capitalism." However, in those instances, capitalism means nothing more than private ownership and a profit motive in the economy. The degree of private ownership, the relationships among private firms, and the extent of government regulation or economic involvement – all differ among "capitalist" countries. They are not following any universal definition of capitalism, since none exists.

Instead, capitalism follows different models. The Anglo-American model prioritizes efficiency and entrepreneurship. The Asian model offers vast, paternalistic corporate groups. The social democratic European model combines strong labor unions and high taxes with an emphasis on social welfare, stability and income equality. China, Russia and India follow their own distinctive models of capitalism. Culture and history are quite influential in determining which model is most appropriate in a given national context. For example, history and culture account for the significant differences between the U.S. Federal Reserve and the European Central Bank.

"Myth Six: The Dollar's Privileged Place in the World Is Lost"

Recent concerns about the dollar losing its role as the world's pre-eminent currency are groundless. The dollar is the currency central banks use when they intervene in markets. Most global trade is invoiced in dollars, the standard currency of oil prices and airport duty-free shops. None of this is likely to change.

"Myth 7: Globalization Destroyed American Industry"

The U.S. central bank, the Federal Reserve, provides other nations' central banks with banking services, including holding their reserve assets. These central banks have done little to indicate any actual change in the currency composition of their reserves. No evidence indicates that they are cutting back on using the dollar at all, so it is in no danger of losing its status as a global reserve currency. On the contrary, it remains the world's most important reserve asset, the one to which other nations turn when market shocks cause fear and flights to quality. The dollar is just as important as it has been throughout recent history, and is likely to remain the pillar of global finance. It is simply too important to world trade and international economics to be displaced. Far from destroying American industry, globalization has helped build it. The first American official to enunciate the principles behind the movement now called globalization was Secretary of State John Hay, who wrote the "Open Door Notes" in 1899 and 1900. Hay proposed ending the system of spheres of influence and replacing it with competition for economic advantage. Hay was speaking specifically of China, but the open-door concept is still recognizable in the global policies nations have implemented since World War II.

> "When a nation chooses to peg its currency to another, it turns its monetary policy over to someone else."

One feature of globalization is local production to serve local markets. When U.S. corporations put factories in foreign markets, usually their motive is not to generate a price advantage over production at home but rather to produce for local sale. America, the world's largest market, has benefited from investments by European and Asian firms hoping to serve U.S. customers. A myopic focus on the trade account by Washington policymakers could be very harmful to America's real economic interests. The trade deficit is not nearly as important as people make it out to be. As noted, the very metrics statisticians use to calculate the trade deficit are flawed and inadequate. America has the most productive economy on earth, with the most efficient and innovative capital markets. The ability to manage far-flung global supply chains is an important competitive advantage for American businesses.

"Myth 8: U. S. Capitalist Development Prevents Socialism"

The United States is not really a "capitalist" country. Through pension funds, mutual funds and other intermediaries, America's workers own its means of production. However, the state is quite heavily involved in the economy. Anyone who doubts this need only look at the programs the government launched in 2008 to cope with the financial crisis.

> "Perhaps it is the uncertainty and pace of change that contributes to people's anxiety, even though they are doing better by objective measures."

Thanks to technological advances, U.S. productive power is so immense that production outstrips demand, which can lead to economic catastrophe. The government has a role in allocating and balancing production. While the U.S. may not be socialist, it is, in the words of Peter Drucker, "postcapitalist." The 2008 credit crisis is likely to result in a bigger, enduring role for government and regulators in the U.S. economy.

"Myth 9: The Weak U.S. Dollar Boosts Exports and Drives Stock Markets"

This is false because, as noted, the dollar has many roles. A weak dollar does make American-made goods cheaper in terms of international currency, but currency rates are so unpredictable that many American manufacturers have preferred to neutralize them by hedging and by locating production of goods for foreign markets within those markets themselves. A weak dollar may actually work against the U.S. stock market by leading investors to keep their capital abroad until they are reasonably sure American investments will not lose value in home-currency terms due to a weakening dollar.

"Myth 10: The Foreign Exchange Market is Strange and Speculative"

The same factors that determine the price of any commodity – supply and demand – determine the price of the dollar or any other currency. However, retail investors should not speculate in currencies, because they do not have the information available to the major institutions in the market – most notably information about what those parties are buying or selling, and why.

About the Author

Marc Chandler, chief foreign exchange strategist at Brown Brothers Harriman, is the former chief currency strategist for HSBC Bank U.S.A. He has contributed to many financial publications, and teaches in New York University's School of Continuing and Professional Studies.
