

ABOUT THE US TRADE DEFICIT AND THE US “EASY MONEY” POLICY

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1. Introduction

As the US economy continues to be the largest in the world and – despite the recent troubles – continues to remain the most valuable in terms of competitiveness, the US Dollar is likely to continue to keep its world reserve currency status. In this kind of respect, there are a lot of discussions (most of them contradictory) taking place but this paper will not be part of them. We will neither discuss the reasons why US became in a position to run huge trade deficits during the last two decades, either – they are pretty much obvious.

2. Overview

First, we have to point out that the US economy did generate high added value at high productivity levels in mid and late 90s and even during the 2000-2005 period of time. Right after the fall of communism (1989-1992) in the former Soviet Union and in Central and Eastern Europe, US had to deal with many world spread armed conflicts and the involvement of US in those conflicts had to be financed. In the meantime, the US economy, as well as the rest of economies of developed capitalist countries (G7 group) had to face a quite severe economic downturn. At that time the US economy was in a relative good position and that mainly because it became to generate high added value goods and services at high productivity levels during the 1979-1987 period of time when Fed, having the famous Paul Volcker as chairman, conducted a very tight monetary policy by operating many

and significant interest rates hikes. Also, the Treasury Department, under the wise leadership of Donald Regan released some quantitative-appropriate and investing-orientated stimulus packages. This smart and complementarily-based combination between the monetary and fiscal policy prized the work rather than investment in risky and exotic financial assets. More else, due to the high interest rates and low inflation economic environment, people were cautious in buying or building expensive houses usually considered some sort of safe haven assets in times of inflationary pressures. We have to add to the picture that, in this kind of economic environment people kept consumption somehow in check and at sustainable levels while remained work and saving-oriented. As result, the US was the very first country where, among many other achievements, the first PC computer as we know it today was created and US was the also the country that putted at the world's disposal the magic product called “the Internet”. We also have to point out that, during the 80s, the achievements in the computers industry lead to increased performances in the banking and financial industries, first in the US, and, then, quite rapidly, in the rest of the world economy. It was also the time when Hollywood entered into the digital era and the entertainment of high-class became available to everyone. In this kind of respect, we have to add to the picture that, despite the Middle East complicated situation (... which, by the way, is always complicated) the refined oil-based gas prices in US were high

indeed (US was and, still, is the biggest oil importer in the world), but not as high as they could have been because the ongoing digital achievements created some sort of new “stay at home” kind of culture, the way that people became less tempted to use their cars. So, the US trade deficit stayed rather contained during the 80s.

In 1990 the Iraq tensions sparked out. The oil prices reached levels they didn't before and the world economy slept into recession. This recession was to be more severe in US as bigger oil importer in the world. Due to this situation, Fed took the normal measure by slashing interest rates from around 6% in 1990 to 3% in 1992. And, at that time, this measure was as best as it could be considering the enormous productivity reserve US had accumulated in the 80s. More else, the Fed's interest rates cuts in early 90s drove down the US Dollar and that made cheaper all goods and services “made in USA” and, this way, a good part of those high added value products conceived and manufactured in US became suddenly competitive in the world. Growth came back starting with February 1993 and all the rest of the world followed suit. The world demand for high performance American made digital and computer equipments increased at an incredible pace and was to last for the almost the 90s decade. The growth in the US's GDP was spectacular during the 90s and even in 2000 and 2001 despite the terrorist attacks at the World Trade Center. The US trade deficit with the rest of the world had risen but, due to the respectable pace of growth in terms of GDP, didn't represent too much concern to the US authorities. More else, the US international trade didn't and doesn't count too much as GDP ratio. For example, the US international trade gap touched a pick in 1987, but it was only 2.5% of the country's GDP. Due to the US Dollar decline after the 1989-1992 period of recession that lead to a strong

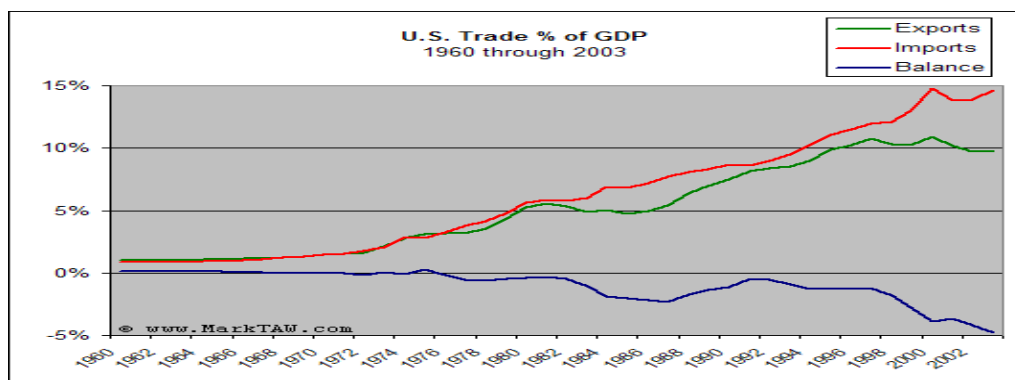
global demand for goods and services “made in USA” and especially digital and Internet-related equipments, the US trade gap decreased below 1% of GDP.

Starting with 1993, Fed begun to raise the interest rates as the US economy showed signs of robust growth. As consequence, the US Dollar started to raise on the international foreign exchange markets. *And here is where – in our opinion – the Fed chairman, Alan Greenspan, big mistake started.* Greenspan, as an experimented economist knew very well at that time as he knows very well today that low interest rates always drives people to assets even the inflation is in check. Fed was not and is not a central bank like any other – it has to manage the dollar's fortune and the dollar was and is the world's reserve currency. He mistakenly thought that rising interest rates at a moderate pace despite a high rate of growth and increasing in value of assets could bring economic growth forever and keep the trade gap in check due to a “not rising too fast currency”. In fact, inflation in US was higher than PPI and CPI showed and that because the price of houses and other domestic assets did increase faster and much more than those of commodities that were took into account at the calculus of PPI and CPI. *Rising price in assets always means potential losing in productivity.* And people went in assets, many of them buying houses and real estate. And the prices of houses and real estate skyrocketed.

On the other hand it's true that Fed had to deal with the Mexican crisis in 1994, the Argentinean crisis in 1997, the currency disorders in Eastern Asia in 1997-1998, the Euro introduction-related currency disorders in Europe in mid and late 90 and with ailing Japan's economy and its banking system collapse. In this kind of respect we do consider that the Fed efforts to keep the dollar as down as possible was not a good thing. It's true that the perception of investors in the 90s

that the dollar is a safe haven was correct and the dollar was maybe higher than the interest rates in US could brought it in terms of yields of governments fixed income issues. But, despite the high yields on US credit markets, the US yield curves on the 10-year T-bond and the 30-year T-bond were too horizontal compared to the pace of growth in terms of GDP. And that

meant losses in productivity. Fed didn't take too seriously the mini-recession of 1995-1996, when, despite a weaker-than-ever dollar, the US international trade deficit fail to improve. *This was a sign of losing competitiveness* (the following figure, source: http://www.marktaw.com/culture_and_media/TheUSTradeDeficit.html).



The recovery that came after was poor in terms of productivity and inflated the price of US domestic assets. Greenspan was misguided by the low prices of gold, oil and other basic commodities that were keeping the “conventional calculated inflation (PPI and CPI)” in check. The truth is that versatile investors had understood that Fed didn't accurately evaluate the situation and – while realizing that the US housing market hadn't reach its pick – stepped into housing and real estate and into housing-related financial assets like home equity funds. That was the main reason the prices of commodities hadn't rise. More else, the US banking regulators were taking by surprise by the banking system new means to raise cash: increasing trade with less liquid collateral debt obligations (CDO) and credit default swaps (CDS)-backed securities. Far from trying to unwind those practices, Greenspan called them “innovations”! The WTC terrorist attacks that marked the beginning of the mini-recession of 2001-2002 and lowered the

dollar did make no improvement in the US trade deficit. This was the very sign that the US productivity reserve reached its end. Wise investors had already been on “exit” from the US housing and real estate market and from exotic CDO-based issues. The terrorist attacks were only a reason like anyone else to ignite the exit of wise investors – they were to do the same thing at one or other moment of time. We have to add to the picture the totally uninspired fiscal policy of Bush administration it chose to deal with the situation: the lowering of taxes. This move released more cash at the disposal of ordinary people that followed the existing trend: they bought houses and bought a lot of housing-related goods, majority of them manufactured overseas. It was a scaring picture: higher-than-ever asset prices, a deteriorating budget deficit, a ballooning trade deficit and a weakening dollar. Such a picture means no productivity gains. The “growth” that followed the mini recession of 2001-2002 was only an asset bubble.

And, starting with the end of 2001, Greenspan began to make its final mistake: he conceded the political pressures and started to lower the interest rates. And the dollar went down without any improvement in the US trade gap. In fact, the US Dollar came down from around 0.9 US\$/EUR at the end of 2001 to some 1.5 -1.55 US\$/EUR at the beginning of 2008 while the US trade gap tripled from a some US\$ 20 billion a month in 2001 to around US\$ 60 billion a month in 2008. In spite of lower Fed interest rates, the yield curve in US gave signs of inversion, starting earlier in 2005. Even Greenspan declared himself "surprised" by this thing in his July 2005 Humphrey Hawkins semiannual testimony before the Senate Banking Committee, but played down risks of recession citing strong domestic demand and betting on a slow decrease in houses and real estate prices. But Greenspan failed to notice even a bigger paradox: the combination between a weakening dollar and an increasing trade deficit. He simply ignored that "growth" accompanied with enlarging trade deficit meant and always will mean lack of productivity and asset bubble. In this kind of respect we speculate that even at that time maybe it was not too late for Greenspan to sacrifice on short term the "growth" US had experienced at that time by starting to hike the interest rates. The result could have been consistent with a slow indeed decrease in home prices and could also have forced the driving forces in the economy to seek productivity. Even that the breakdown in price of assets could have happened brutally (as it did) and the unemployment could have got higher, Greenspan should have had to release that those things are unavoidable anyway and was (and is) far much better to confront layoffs and decline in home prices at high interest rates rather than at low interest rates: the raises in productivity could (and would!) eventually have solved those issues. Greenspan also didn't realize that, in

spite of lax monetary policy, cash could (and did!) easily become scarce without productivity. More else, in the absence of adequate regulations, if started earlier (let's say 2003), a tighter monetary policy could also have putted to a short end the dangerous trade with not liquid home equities based CDOs and CDSs between banks and unwind the greedy and reckless subprime practices that, finally, brought the fallout of Bear Sterns and Lehman Brothers, in early 2008. We have to add to the picture that the deregulations operated in the mid 90s on the housing market went too far and many people from Fed and the Treasury Department knew this very well. In this kind of respect is very hard to conceive that "government sponsored" entities like Fannie Mae and Freddie Mac were allowed to be market makers by themselves and bring further distortions on the market using the taxpayers money!

As part of this discussion, still remains the question if a stronger dollar which had been expected if we had seen hikes in interest rates starting with 2003 could or could not have had a bad impact on the trade deficit. The answer is: maybe yes, but the gains in productivity and innovation would eventually have fixed the problem on mid and long term.

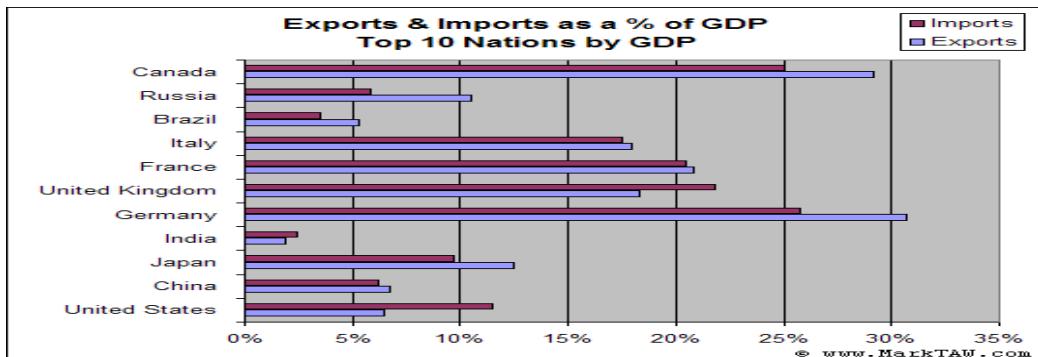
But this is the past. The done things are to remain nothing but done. The US housing market crashed and a lot of financial institutions went bankrupt. In this kind of situation, a lax monetary policy from Fed does make sense. But even at the actual 0% to 0.25% Fed funds rate, banks are reticent in lending money in order to re-launch the growth and that because (yet!) they don't see any source of creating added value products. In times like this, fiscal stimulus packages usually do work and that's exactly (and correctly, in our opinion) the Treasury Department has done: the Treasury accepted Fed to make a rare open market operation called "quantitative easing". In a very simple

way, this operation enabled Fed to release some US\$1.3 trillion that have to be covered with long term government backed securities. But this is only a part of the operation. The Treasury also agreed, between other things, to buy CDOs and CDSs for an amount of some US\$ 300 billion in order to clean the asset portfolios of banks involved in transactions with such strange kind of financial papers.

Of course, such huge amount of US Dollars drove the dollar further down on forex markets, and this put the trade gap down from about US\$ 60 billion a month in 2007 to some 25 to US\$ 30 billion starting with early 2009. In this kind of respect, we have to point out that the trade gap was brought down more by the lack of cash in US and less by the adding in competitiveness due to a weaker dollar.

In the meantime, the IMF, having US as main shareholder launched an unprecedented action to lend money, especially to emerging economies. So, the quantitative easing was made not only for the US economy but also to sustain the assets in the entire world. A worldwide fall of assets prices could be a mess for the international financial and banking system and that could bring a huge global economic depression. While sustaining the world sensible economies and keeping down the dollar, the US trade gap is likely to improve as the US

high added value tech sector shows some credible signs of revival. Also, a weak dollar will put further pressure on China's unfair trade practices. Speaking about China, our opinion is that it seems very unlikely to sell on forex some part of its US\$ 2 trillion People's Bank of China. Such a move could bring further pressure on the dollar by making the Chinese made products more expensive in US. In this kind of respect we strongly believe that China is not in such a good position that many people are tempted to believe: China, at least for the time being, does produce only small added value products and, sooner or later, the competitive advance it has, due to its literally cheap workforce will disappear. In the same kind of respect, we also have to add to the picture that the international trade doesn't count too much in the US GDP and that makes US less vulnerable that many analysts believe to the global demand for goods and services. Also, we have to point out (the following figure, source:http://www.marktaw.com/culture_and_media/TheUSTradeDeficit.html) that a lot of very high added value products like high tech military equipments or high performance computers are banned to be exported by the US federal administration. But it's true that a strong global demand, especially for civil high tech equipments, does mean a really strong stimulus in creating high added value in US and improving productivity.



But, sustaining global assets in order to escape a liquidity trap that

occurred in the US economy cannot be sustained forever. We mean that, unlike

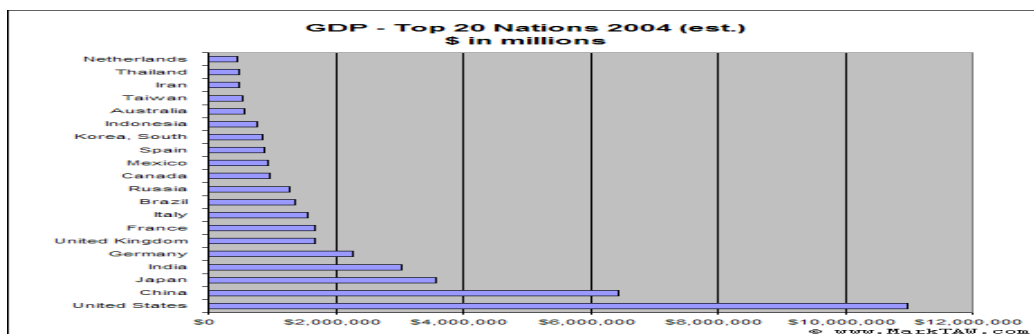
the Japan case in late 90s and early years of the 2000 decade, using this huge “quantitative easing” measure, US consciously ignited an also huge “US Dollar carry trade” phenomenon. Compared with the magnitude of this existing dollar carry trade, the passed Japanese yen carry trade means almost nothing.

But, this time, the US authorities seem to be aware of what is happening. Once the growth will come back in the global economy (and there are a lot of good signs concerning this issue), Fed will start to increase the interest rates and the US Dollar will start to rise and that will be to unwind the dollar carry trade. If the things will follow the right direction, when the dollar will start to rise, the US trade gap will be small enough that US will afford to allow it to enlarge, with one and single condition: at that

time, US will be already generated some quite strong added value the way that it will be able, despite its “new” kind of trade gap , to make really strong capital gains in terms of competitiveness and due to its new productivity improvements. This way, US will be again a huge market (of different kind, but still huge) for the most goods and services produced all over the world and the stop in the dollar carry trade will be mild and smooth.

3. Conclusions

The chance that things will happen this way is really big. The US is and will remain for quite sometime the largest in the world (the following figure, source:http://www.marktaw.com/culture_and_media/TheUSTradeDeficit.html).



More else, the US economy has a flexibility that any other country don't even dare to dream on. And, despite the recent “not so good things” concerning the moral hazard, but considering its yet

not matched corporate sector and its unique universities, still remains the best place in the world to create high added value goods and services.

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