WHO IS ENGAGED IN A TRADE-RELATED FAUSTIAN BARGAIN?

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I am going to present arguments that support the idea that the major Central Banks of the world do not have any incentive to let their currencies appreciate sharply against the dollar. In fact, those who let their currencies appreciate, do so at their own peril, as they would lose their competitiveness when exporting to the major buyer of their products, namely the US. If anyone has entered into a Faustian bargain, it is the Japanese and the Germans, who need to sell their surplus domestic auto production to their largest customer, again the US. The cost of this export-led growth is the loss of purchasing power of their domestic laborforce. However, this does not mean that the US can continue with its record trade deficits forever, but the probability of an abrupt and sharp devaluation of the dollar is very small.

Ben Bernanke, the former Federal Reserve Bank Governor and soon-to-be Chairman of the President's Council of Economic Advisors, recently presented evidence in a speech on March 10th that there is a global savings glut which has emerged very quickly in the last ten years. Table 1, reproduced from his speech, clearly shows that industrial or developed countries collectively borrowed $342.3 billion in 2003. They have gone from being net lenders of $46.2 billion in 1996 to big debtors now. Countries that finance this debt are the developing nations and Japan. Nowadays, capital flows from poor nations to rich ones, whereas economic theory posits the reverse of this: from rich to poor nations who need funds to develop. This conundrum, in turn, helps the US finance its record current account deficit. But how?

First we have to look at US imports and exports on a net basis. Table 2 shows the 2004 US trade balance for top 10 commodities. Notice that almost forty percent of the trade deficit is made up of two commodities: oil and vehicles, which are complementary goods. From Table 1 you will notice that Germany, Japan and the Middle East, including Africa (mostly Nigeria), runs a surplus that is roughly equivalent to the trade deficit in these two categories. Asian economies, especially China, are the provider of basic consumer goods to the US. In return, they end up with surplus dollars which they need to park somewhere.

Table 1: Global Current Account Balances

(Billions of U.S. Dollars)

Countries	1996	2003	Countries	1996	2003
Industrial	46.2	-342.3	Developing	-87.5	205.0
United States	-120.2	-530.7	Asia	-40.8	148.3
Japan	65.4	138.2	China	7.2	45.9
Euro Area	88.5	24.9	Hong Kong	-2.6	17.0
France	20.8	4.5	Korea	-23.1	11.9
Germany	-13.4	55.1	Taiwan	10.9	29.3
Italy	39.6	-20.7	Thailand	-14.4	8.0
Spain	0.4	-23.6	Latin America	-39.1	3.8
Other	12.5	25.3	Argentina	-6.8	7.4
Australia	-15.8	-30.4	Brazil	-23.2	4.0
Canada	3.4	17.1	Mexico	-2.5	-8.7
Switzerland	21.3	42.2	Middle East and Africa	5.9	47.8
United Kingdom	-10.9	-30.5	E. Europe and ex-USSR	-13.5	5.1

Source: Remarks by Governor Ben S. Bernanke, March 10, 2005

Table

Table 2: 2004 US Balance In International Trade*

What We Buy From Them		What They Buy From Us	
Crude Oil	-135.7	Airplanes	13.2
Vehicles	-123.2	Chemicals (Plastic)	10.9
Clothing	-67.9	Airplane Parts	10.5
Home Electronics	-67.8	Soybeans	6.6
Office Electronics	-65.6	Corn	6.0
Petroleum Preparations	-28.3	Wheat	5.0
Furniture and Bedding	-23.7	Scientific Instruments	4.5
Natural Gas	-21.1	Cotton	4.2
Electrical Machinery	-20.2	Metal Ores	3.2
Toys, Sporting Goods	-19.1	Animal Feeds	3.0

*Net Balance In Billions of Dollars

Now the game gets really interesting. If I am a private investor abroad looking to park my dollars, I can park it in stocks, bonds, a risk-less asset or any combination of these three asset classes (I can also just keep the dollars in cash under the mattress!). Let me first eliminate from my choice-set places where returns are abysmal (Japan), or where there are strict capital controls (India, China, etc.), or where enough opportunities aren't needed or provided to park the money. For example, Norway runs a budget surplus equivalent to 10% of its GDP! Australia may seem like a great opportunity but their entire supply of outstanding government bonds can be bought by one bank in Pittsburgh, not leaving much for me! You get the point. What I am asking for are valid strategies that allows one to park billions in one go. A counterpart to this problem happens in real-estate investing, when investors who need to park, say, a billion dollars at once tend to avoid towns like Atlanta or Charlotte, as these cities have no commercial buildings that have ever sold for more than $350 million.

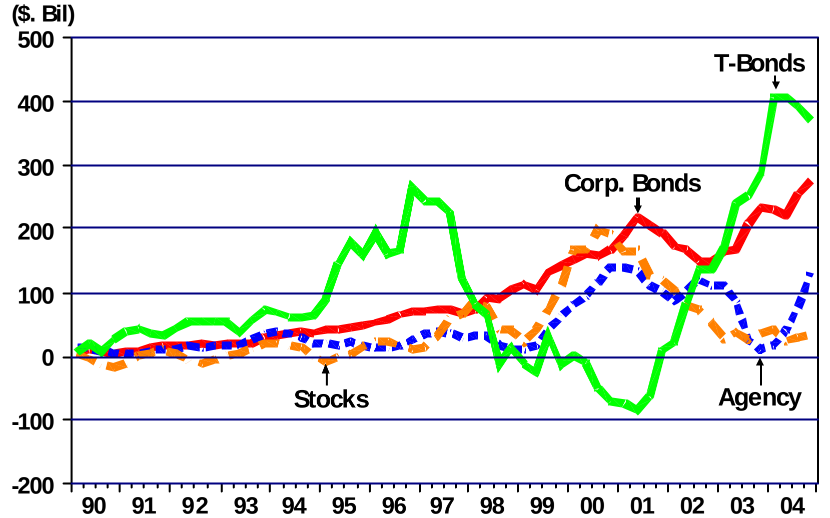
I can do the investments in dollar-denominated assets or in any other currency, such as the Euro, which is darling of the media and pessimists these days. Sorry, no deal on the Euro as I will first have to convert dollars into Euros, which will cost me, and then I have to go looking for assets to invest in Europe. I might find some in Portugal or in Spain, but again, the scale problem arises. This leaves me with Germany as a candidate. But then I notice that Germany is experiencing a stagnation bordering on deflation in real-estate prices, is also flirting with bouts of consumer price deflation, and has had a weak domestic spending pattern leading to an anemic economic environment.

Very quickly one starts to think of investing in some other place. Two logical choices come to mind: the US and the UK, who seems to have a much more vibrant economy than the rest of the Europe. The UK seems like a good choice and I plan to invest there in spite of having to suffer conversion costs. But then again, I run into the scale issue. Not enough good investments for the collective body of investors as a whole. This leaves me no other choice but to come back to the US. "These guys are amazing!" I think aloud. They run a big trade deficit but their asset classes pay way more than what I will earn in my own country (imagine you are a Japanese investor). To boot, scale is a non-issue. Buy the GM building in New York or the Sears Towers in Chicago and park a few billion in one go. Buy a half percent of GE or CISCO stock and you can park another few billion. At this point, I am in hog-heaven and I get to own a piece of America. Remember Mel Gilbson's cable-cult movie Air America, where the Cambodian general running the heroin ring remarks to Robert Downey Jr. that his dream was to run a Holiday Inn in California?

But what if I am in a country with strict capital controls where all foreign currency transactions are to be done by the Central Bank (like India, China, and Malaysia)? Aren't I in trouble of not being able to get maximum returns by investing freely? Not at all. Fortunately, my own central bank is trying to stop the domestic currency from appreciating against the dollar, thereby protecting my earnings from capital losses. I reconcile to my constrained equilibrium situation and let them invest on my behalf. If I live in a culture that is either a command economy (China), a border-line socialist economy (India), or an outright paternalistic (read Korea, Malaysia and Singapore and to some extent Taiwan), it means that I readily accept this by-product of export-led growth at any cost.

Next, it so turns out that Central Banks have mandates that either don't allow them to invest at all in stocks, corporate bonds or even agency bonds (Freddie and Fannie's mortgage-backed securities), or they have to limit their exposure to these investment classes so as to minimize the possibility of capital losses on their balance sheets. Capital preservation is the key mandate, which leaves them with no choice but to invest in a risk-less asset, and the gold standard in the world economy is the US government bond.

Figure A. Net Foreign Purchases of U.S. Financial Instruments



Source: Federal Reserve Bank Flow of Funds Data

Did I hear a pitch about Euro bonds? If I did, then I will dismiss it by putting forward this simple argument. Eleven national elections resulting in eleven independent fiscal policies and only one monetary policy tool to balance it (I am not counting the new EU entrants here). This sounds to me to be a case of ten missing policy instruments to balance these diverse national objectives. Something has to give and how-so-ever remote the possibility of a union dissolution, it exists in the eyes of a bond trader. While not infinitesimal, it is definitely larger than the probability of the US government defaulting on its promises. The bond traders are the ones who provide liquidity in these markets, especially in a market that has been in existence for just over four years. Again, the scale issue comes up. The Euro zone as a net is not running a deficit, so a large supply of these bonds doesn't exist to satisfy the urges of an Asian Central Bank.

Figure A shows the breakdown of net foreign purchases of US financial instruments since 1990. This is the flip side of the trade deficit or capital inflows (subject to statistical discrepancy). From 1994 to 1996, treasury bonds were in high demand and then lost favor as the US stock market took off after 1996. Following this the net treasury bonds position went from a positive $250 billion to minus $100 billion by late 2000. Since then, stocks have given up major ground, as well as agency bonds, but there has been a net change of $500 billion for treasury bonds. This also roughly coincides with the change in the US fiscal deficit. Talk about a marriage made in heaven. The federal government needs to borrow money to finance its runaway spending and willing foreign lenders are there to snap them up as fast as they are printed. No wonder long-bond rates have remained low and our consumption binge has not suffered any negative consequences like a normal economy certainly would!

So who is buying those bonds and for what purpose? The first few columns of Table 3 show the US trade deficits with its major trading partners in 2004, and the net change in that value compared to 2003. First, I have listed the Asian countries (like China) to which the US seems to have increased its deficit the most. For completeness sake, I have also shown two major European trading partners of the US with whom it runs deficits. The next few columns show the US Treasury Security holdings of these countries in 2004, and the net change in that position since 2003. The last column shows the currency appreciation in the last twelve months for these countries.

Quite a few facts emerge from examining these columns. First, the Japanese trade surplus grew a little but Japanese holdings of US treasury bonds grew by a multiple of 40! Why such a large change? They were intervening to keep the Yen from appreciating too much, plus they were trying to achieve better returns than what they were making by holding their own government bonds (the Japanese 10-Year bond yield is less than 1 %!). China in order to maintain its dollar peg also bought US treasuries that exceeded of the increase in their trade surplus. But the big surprise

Table 3: Trade and Securities

	Trade in Goods and Services		U.S. Treasury Securities Holdings		Currency Appreciation (2004)
	2004	Change	2004	Change	
Japan	-75.2	-9.3	702	353.7	4.3
China	-162	-38.1	196	49.4	0.0
South Korea	-19.8	-6.9	67.1	8.6	13.4
Taiwan	-12.9	1.2	59.1	18.2	6.7
Hong Kong	6.5	1.8	52.9	22.7	0.0
Singapore	4.3	2.9	26.9	4.1	4.1
Germany	-45.8	-6.6	59.5	19.5	8.0
UK	-10.4	-1.7	171	124	7.1

Source: US Census Bureau (trade figures) and US Treasury Department

* All numbers are in billions of U.S. dollars

here is the UK. Its trade surplus with the US changed by only a few billion but they bought $124 billion in US treasuries, a mind-boggling number considering the fact that the UK runs an overall trade-deficit that is about 2 percent of their GDP! Why did they do this? Because they didn't want the pound to appreciate too much against the dollar.

The only anomaly here is South Korea. The Korean Won has appreciated against the dollar by double-digits. Korea holds 1/3rd of its foreign assets in the form of US treasury securities but hasn't bought any more than what the increase in their trade surplus has been. In March, it roiled the bond market in the US for a few days when it announced that it will need to look beyond US assets in order to diversify its foreign-asset portfolio. This warning, in my viewpoint, was in frustration to an indifferent US response to the North Korean announcement that they had nuclear weapons.

As I have argued above, the South Koreans will be hard-pressed to come up with alternatives to investing in US treasuries. Second, moving away from the dollar into other currencies will entail capital losses on their Central Bank's balance-sheet, which could be substantially large if done hastily. Dumping US treasuries would be akin to a submarine shooting a torpedo at its own oil-supply tanker while being refueled. The ensuing explosion will destroy them both. These countries still have the 1997 currency crisis fresh in their minds, and the only thing that stopped the meltdown before was its dollar reserves.

Thus, mass dumping of US treasuries by Asian nations, whether coordinated or not, will lead to losses that will destroy the balance sheets of these banks. These are not rich countries and not even Japan can afford losses that are that substantial. Now, if you and I see them selling dollar assets slowly in order to invest in their own countries, this will imply that the investment opportunity drought, which resulted in a global savings glut, is now over. Global mobility of capital also implies that we all will follow the same investment trail to earn better returns. In this case, the dollar may even drop sharply, but what one loses in currency depreciation, one makes up more than enough in higher returns. For the foreseeable future (say till the end of this decade), I don't see this big-bang happening. The reason for this is evident with the help of the following illustration.

How Workers in Foreign Countries Subsidize Cars Imported to the US!

Folks, this is true. If you buy a foreign-made car in the US, part of your purchase price was already paid for by the worker in the foreign country where it was manufactured. Let me prove it.

Table 4 shows the domestic production and sales of passenger cars in a country. One thing is very clear from examining the table. Japan and Germany have a net surplus production of approximately 5.8 million cars whereas the US has a deficit of 3.5 million cars. The US is the biggest car market and, I would say, the only market outside of the UK where one can park excess production. Did I hear somebody mention China? Chinese car sales did grow at a 40% rate in early 2004 to the 1.5 million level, but have stagnated recently as it has tried to slow down its economy. For the sake of argument, if this growth rate somehow continues, it will be another five years before they get to levels sufficient enough to absorb excess world production. We are now talking of an event like NASDAQ shooting up in 1999 for five years in a row! Highly unlikely.

Table 4: 2002 Passenger Car Production And Sales

Country	Production	Sales	Deficit/Surplus
Japan	8,117,563	4,289,683	✓ **3,827,880**
Germany	5,301,189	3,341,718	✓ **1,959,471**
U.S.	4,879,119	8,422,625	**-3,543,506**
France	3,181,549	2,254,732	**926,817**
S. Korea	2,471,444	1,065,161	**1,406,283**
Spain	2,211,172	1,437,192	**773,980**
Brazil	1,495,622	1,295,119	**200,503**
U.K.	1,492,365	2,458,769	**-966,404**
Canada	1,274,853	868,188	**406,665**
Mexico	1,000,715	667,565	**333,150**
China	703,521	780,604	**-77,083**
India	573,808	601,321	**-27,513**
Sweden	251,035	246,581	**4,454**

Source: Ward's World Motor Vehicle Data

The short-term solution to this excess production capacity is to keep doing what you are doing, but there is a limit to how many concessions you can wring out of your labor force. In the long-run, everybody will follow the example of Toyota, which started putting its car manufacturing plants in the US. Doing this will not only get rid of the currency appreciation issue but also the political flak that comes from running consistent trade surpluses. They learnt this during the voluntary export restraint program of the mid-80's. South Korea needs to follow this example even more as their currency is the one that has been appreciating the most. The Germans are already here but they need to expand more. All this may be bad news for workers back home but it will solve one-fourth of the US trade deficit problems, and might add jobs to boot.

On top of this heroic growth assumption, one has to consider the issue of price. The stuff sold by BMW, Mercedes, Toyota and Honda is of a luxury variety. Who apart from the American consumer can afford them? Certainly the rich Koreans, Indians and the Chinese can buy some, but not on the scale these producers need to sell. The point is that these producers collectively are dependent on one buyer for the majority of their sales. The power of this consumer is so strong that even with the Euro's 50% rise against the dollar in the past few years, car prices in the US have hardly nudged up (as my own recent personal experience proves!).

This is bad news for the foreign manufacturers facing currency appreciation. They are forced to cut their workers' paychecks to pay for the increased cost of selling a car in the US because they can't take a hit to their profits when shareholders are clamoring for returns. To give an example of this drive, Volkswagen recently reached an agreement with its unions to take back current and promised future pay-raises. The threat was that if you don't agree to this proposition to make us competitive, then the Japanese producers will be here to take over the business. Either work for us or good luck working for the Japanese. In effect, the German worker is paying part of the US consumer's purchase price. When I joked about this to the Mayor of Düsseldorf, who visited Atlanta last fall, he said "Don't worry Rajeev, we got rid of the workers. The plants are now fully automated!" No wonder Germany has a 12.0% unemployment rate.

Now for the other big item: oil. Conservation imposed by high prices is expected this decade and a move towards nuclear energy will do the trick. The reason why the US is producing only 20% of its electricity from nuclear power plants whereas France gets 70% is a case of over-blown hysteria from the Three-Mile Island incident two decades ago. Nuclear energy is cheaper, safer and the only long-term solution to the world's energy problems. Solar and wind power will always remain at the fringe or at the niche level.

For the other half of the trade deficit, US will have to produce more in service exports and high tech manufacturing even if it can't be competitive in traditional manufacturing sectors. If you remember the surplus column from Table 1, it had some surprising items, chiefly agricultural. With the world's growing population, the US will have to become more efficient in agriculture to close the gap. All this will be a process that will take some time, perhaps another ten years at most.