

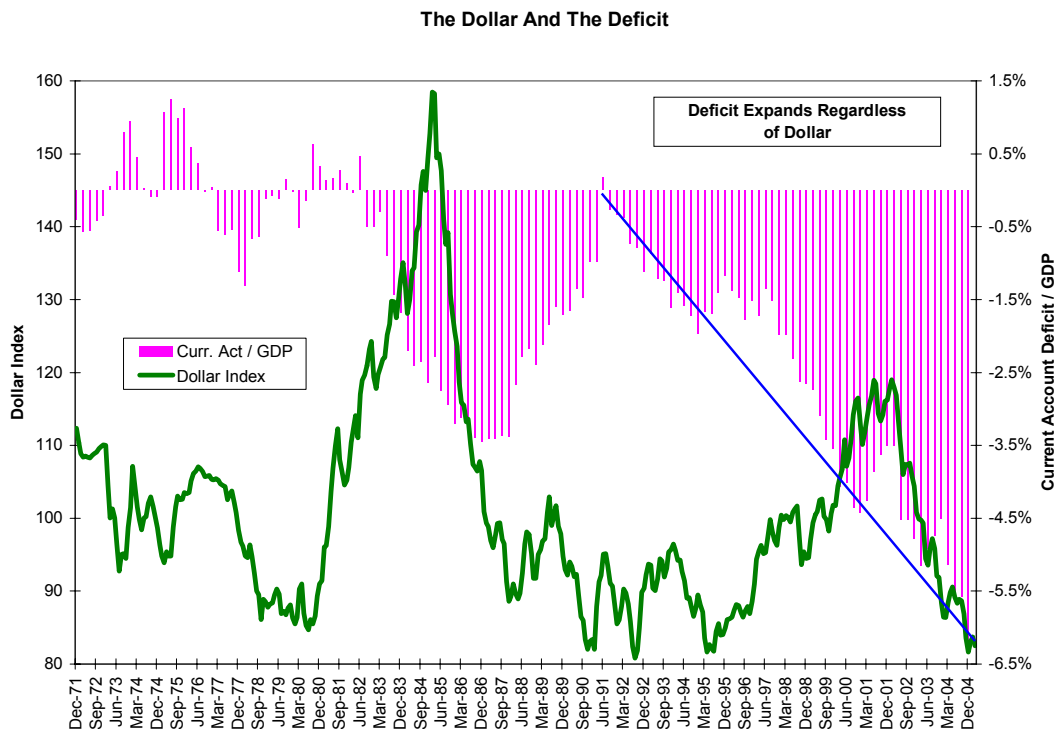
The Rise And Fall Of The Merchandise Trade Report

During the mid-to-late 1980s, the merchandise trade report was the most important economic datum of the month. It acquired this status after the 1985 Plaza Accords wherein the U.S. agreed to drive down the value of the dollar to address its growing monthly trade deficit. The assumption, derived from equal measures of conjecture and fantasy, was each deepening of the trade deficit would be greeted by a further weakening of the dollar. You know the tactic: If something does not work, just keep doing it a little louder tomorrow and hope for the best.

First, no one has yet explained whether a zero balance of trade, one where imports and exports are equal, should be a goal of national policy. During the fixed-exchange rate regime extant between World War II and the early 1970s, the answer to this question would have been a qualified “yes.” Under such a system a country in perpetual deficit eventually depletes its reserves of either gold or convertible currencies and has to limit its imports to whatever is provided by vendor financing. In such a system, periodic crises ensue, and the occasional devaluations or revaluations of currencies become market-jarring events. The original purpose of the International Monetary Fund was to stabilize countries in such deficit crises.

The ensuing system of floating exchange rates, which has been with us for better or worse for more than three decades, was conceived by Milton Friedman and others as a self-correcting way of having the exchange rate modulate trade flows. The idea was as a country moved into deficit, the units of its currency paid to its suppliers would be worth less on world markets. Its exports would become cheaper and its imports more expensive. The opposite would be true for those countries in surplus: Their imports would become cheaper as their currency rose in purchasing power and their exports would become more expensive.

Has this been observed in practice for the dollar? Not in the least: Whether the dollar has strengthened or weakened since 1971, the U.S. has remained in near-perpetual deficit on a merchandise trade basis. The last surplus occurred in April 1976. The current account balance, reported quarterly as part of the GDP estimates, and which includes flows of services and official transactions, has been in surplus as recently as 1991; official payments received for the Persian Gulf War did the trick. The current account deficit as a percentage of GDP has expanded steadily since that date regardless of the dollar’s course. As the two measures of trade capture the same concept, we will use the current account deficit as a percentage of GDP in several of the long-term charts below.



The answers why floating exchange rates have done little to address the U.S. are legion, but not all that complex. First, many commodities such as petroleum and metals are priced in dollars globally; despite period rumblings out of OPEC about pricing oil in a basket of currencies, this is unlikely to change anytime soon. A second reason is the prevalence of currency blocs. The euro is the most noted result of these amalgamations, but the U.S. and China have a de facto dollar bloc by virtue of China's decision to peg the yuan to the dollar. Other Asian exporters, most notably Japan, engage in currency manipulations to keep their currencies from straying too far from the dollar. A third and critical reason is the large role of both Canada and Mexico in our external trade balance. We are in a free trade zone with both countries, and it is unclear whether trade between Michigan and Ontario is really all that different than trade between Michigan and Ohio.

Other reasons why exchange rates have not mattered is the ability of affected exporters to make wage and price adjustments and to engage in foreign direct investment. Japanese automakers, for example, responded to the stronger yen over the years by accepting lower profit margins, lowering production costs and shifting production to low-cost zones, such as Mexico and Brazil. Many American firms did the same - see the *maquiladora* plants in northern Mexico - with the result being much of our trade is really intra-company transfers from one subsidiary to another. Finally, American consumers demanded and received wage adjustments to compensate for the reduced global purchasing power of the weaker dollar.

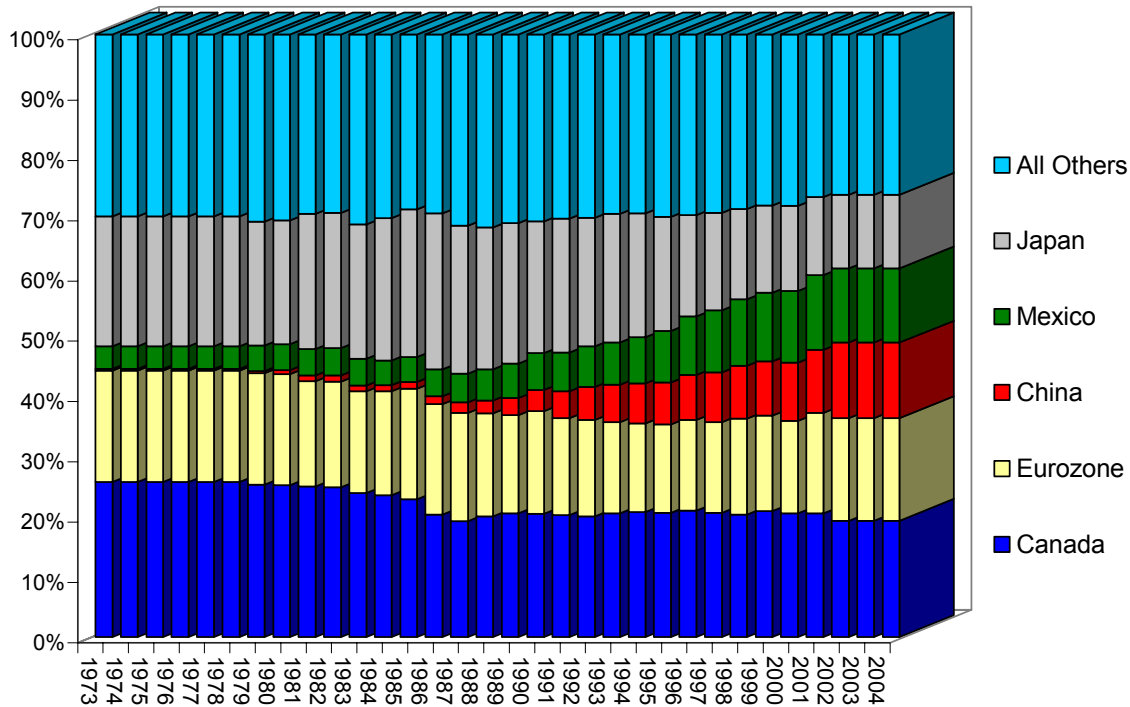
Finally, the most important reason of all is the disconnection between financial flows and physical trade flows under a floating exchange rate regime. The mechanics of controlled interest arbitrage, the basis for currency trading, do not require any physical trade to support a vast amount of currency trade.

We can see the growing role of Mexico and China in the U.S. import mix by tracking the history of the Federal Reserve's trade-weighted dollar. This dollar index differs from the one commonly tracked and traded on the New York Board of Trade's FINEX division. The FINEX' weights have not been updated since its inception in 1973; the only change has been to aggregate the appropriate European currencies into a weight for the euro. Together, the six currencies represented in the FINEX dollar index - the euro, Canadian dollar, Japanese yen, Swedish krona, Swiss franc and British pound - accounted for 53.91% of U.S. trade in 2004.

Changing Pattern Of Trade

As noted above, China has pegged its currency to the dollar, and the Mexican peso has been in a long-term decline against the dollar. A weaker dollar therefore would do little to address the growing importance of both countries in the U.S. import mix. We can see the growing role of Mexico and China in the U.S. import mix by tracking the history of the Federal Reserve's trade-weighted dollar. The displacement of goods previously imported from Japan by goods now imported from Mexico and China is quite apparent; the trend has accelerated markedly since the early 1990s, and there is little reason to expect a reversal.

Total Import Weights For U.S. Dollar



As an aside, this dollar index differs from the one commonly tracked and traded on the New York Board of Trade's FINEX division. The FINEX' weights have not been updated since its inception in 1973; the only change has been to aggregate the appropriate European currencies into a weight for the euro. Together, the six currencies represented in the FINEX dollar index - the euro, Canadian dollar, Japanese yen, Swedish krona, Swiss franc and British pound - accounted for 53.91% of U.S. trade in 2004. The euro alone counts for 57.6% of the FINEX' index weight, but the Eurozone accounted for only 18.53% of the total U.S. trade mix in 2004.

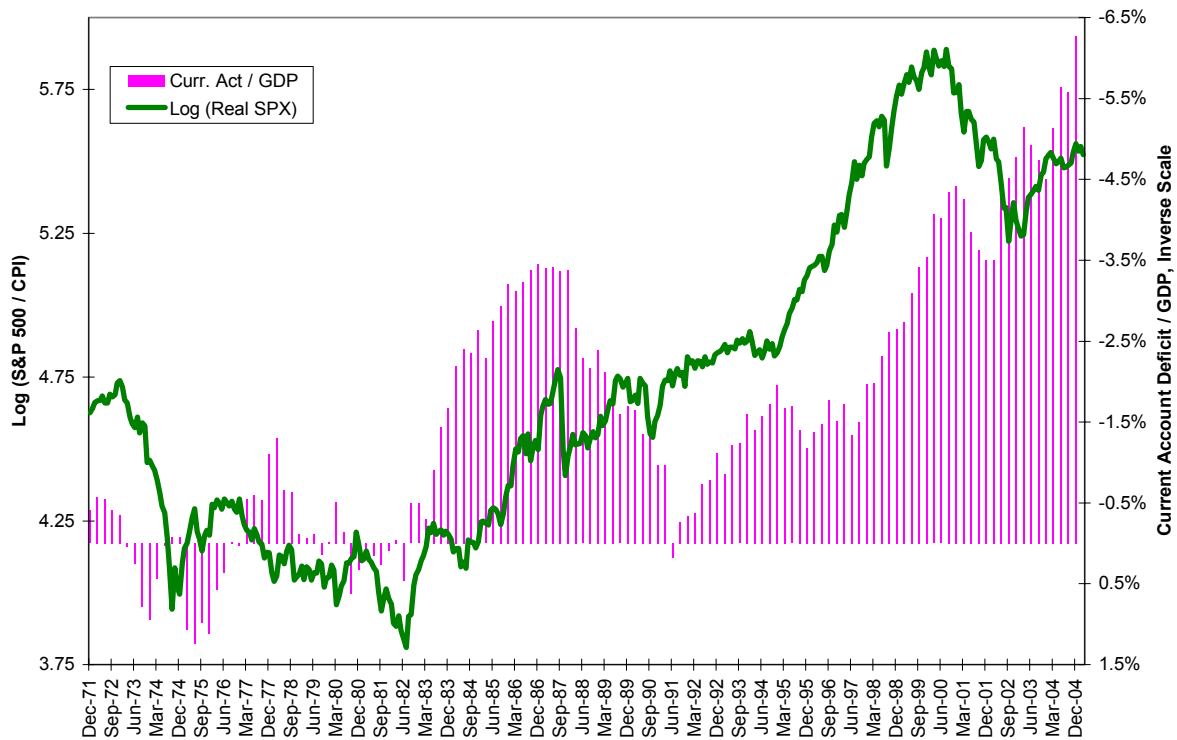
In fairness, the Federal Reserve's index would not be particularly suitable for a trading instrument; leaving aside issues of whether it would be appropriate business for the central bank, many of the currencies involved are illiquid and thinly traded.

Just Another Report

As a result of the previous failure of dollar depreciation to correct the U.S. trade deficit and in recognition that our largest import growth is from two countries whose currencies are linked to the dollar in one way or another, the market no longer expects a policy response to whatever the monthly merchandise trade report says. It is now just another report, on the order of durable goods or retail sales. You have to remind yourself at the end of the day it actually was released in the morning.

Does it still affect other markets? The stock market often does quite well when the current account deficit deepens. If we plot the inflation-adjusted S&P 500 on a logarithmic scale against the current account deficit as a percentage of GDP, we see how two of the biggest upsurges in stocks, the mid-1980s and the late-1990s, coincided with widening deficits. A stronger U.S. economy pulls in imports, and these imports often replace higher-priced U.S. goods. The net gain in economic efficiency leads to expanded corporate profitability and higher stock valuations.

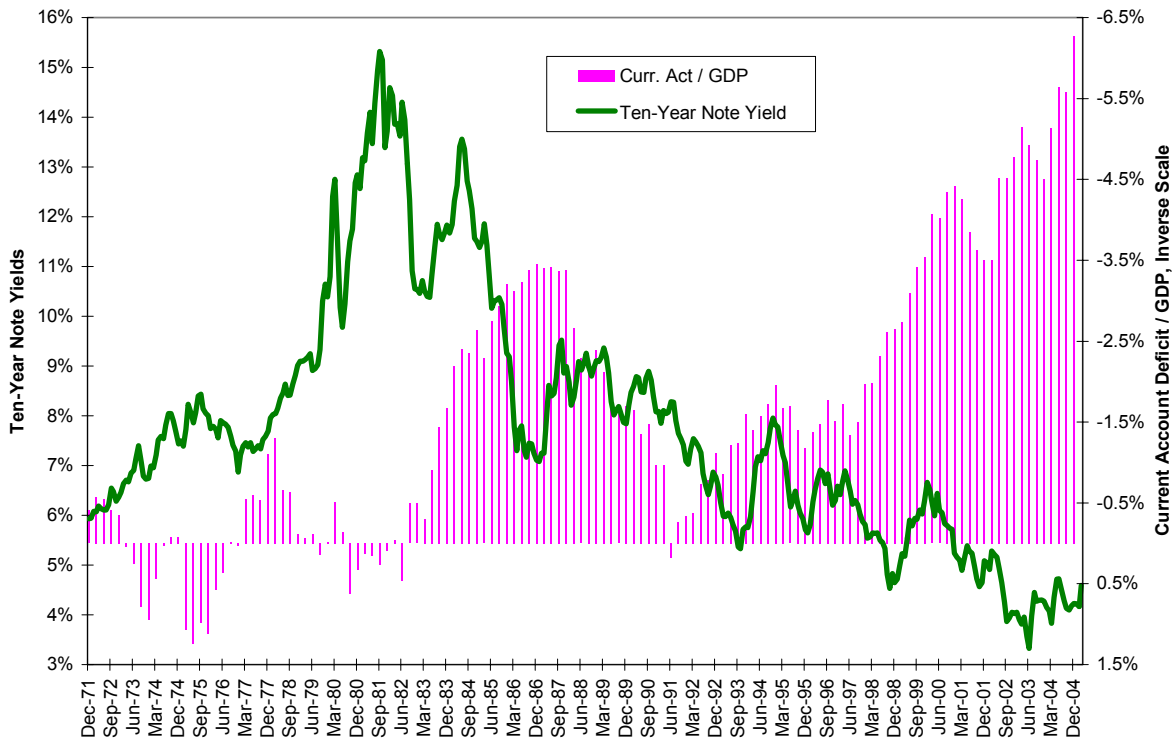
The Current Account Deficit And Stocks



Even more telling, however, is what happens when the currency account deficit starts to contract, as it did between 1988 and 1991 and on a smaller scale during 2001-2002. Neither period saw a bull market in stocks; indeed, the latter episode coincided with the worst bear market since the Great Depression.

Finally, many have warned that the ever-expanding current account deficit would lead inevitably to higher interest rates as foreign investors would demand higher interest rates in compensation for the risks created by the expanding debt load. Maybe this shall come to pass, but in the meantime we have to wonder why the greatest upsurge in ten-year note yields, that between 1971 and 1981, occurred while the U.S. current account balance oscillated around zero. We also have to question why the opposite has been true: Since late 1981, note yields have fallen more or less continuously while the current account deficit has been in near-permanent deficit. At some point those who warn of a bond bear market engendered by these expanding deficits should either apologize for three decades of error or find another theory.

The Current Account Deficit And Note Yields



Will the monthly merchandise trade report ever rise to its old glory again? Anything is possible, but let's hope not. The whole concept of surplus and deficit appears to bring out the worst instincts in many traders, economists, politicians and commentators. Some may feel a need to call for an impending payback for the U.S. living beyond its means and for imposing excessive claims upon the world's pool of savings. But if we cannot demonstrate any sort of causal connection between the trade data and variables such as the dollar, stock returns or bond yields, and if we cannot demonstrate any connection between the dollar's level and direction and any of these trade measures, then we should pay no attention to this report, now or in the future.