Currencies' Trade Weight Problem

I noted two days ago the currency markets were becoming unanchored and yesterday how financial repression was leading to the primacy of trend-following in the money-printing era, so let's conclude this week's volleys by noting one of the nearest-and-dearest theories of exchange rates works only in the breach.

The original thinking behind floating exchange rates was they would lead to self-correcting trade imbalances. Countries running a surplus would see capital flow in, their currency would rise, their exports would become more expensive and their imports would become cheaper. Too bad it has not worked in close to 40 years of practice; you could wander around the desert that long and come to the only place in the Middle East without any oil.

The reasons are myriad and range from the J-curve (a lag between currency changes and trade flows) to the large number of price-insensitive goods in international trade (think dollar-denominated military hardware; what, you are going to buy Russian equipment?) to exporters' willing and ability to absorb price changes in margins to the ability of all parties to hedge their risks.

I analyzed both import and export trade weights used by the Federal Reserve for their – you guessed it – trade-weighted dollar index; this is a set of 26 different currencies going as far back as 1973. Countries have come and gone since then; the aforementioned Russia is not in the data set until 1993, and China was not even measured until 1981.

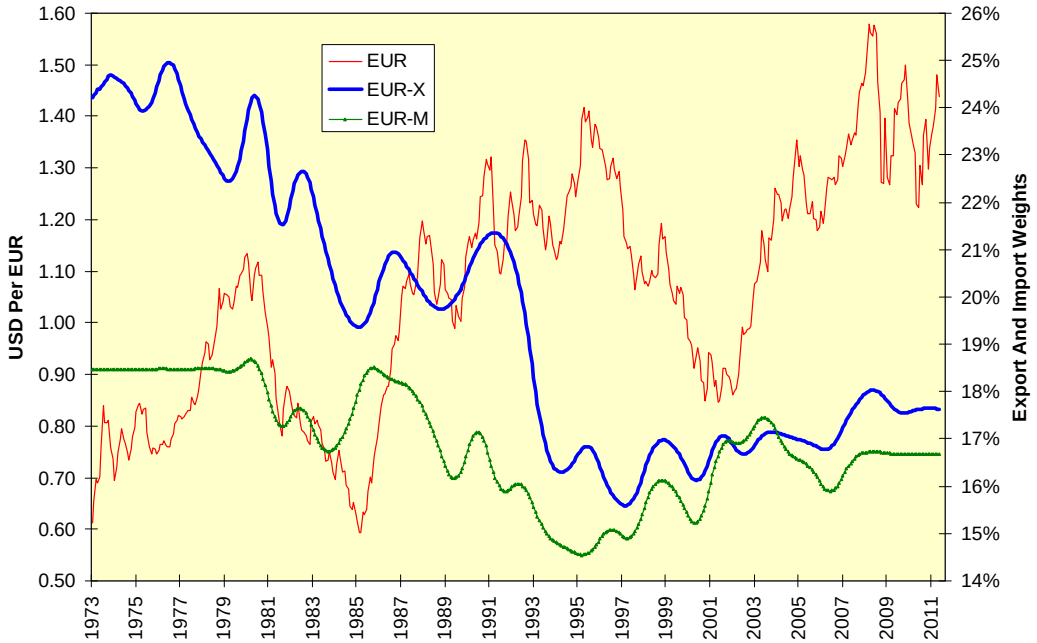
I will state the conclusion up front: Trying to change trade patterns via currency manipulation simply does not work. You see many examples of U.S. import weights for strengthening currencies rising and export weights to those same currencies falling. The two biggest factors over the analysis were the 2008-2009 global recession and the long-term rise in emerging market national income levels.

Other situations found in abundance are static trade weights to and from various European countries, including but not limited to the members of the European Monetary Union. The dollar/euro exchange rate dominates our mental perception of the greenback and of closely followed indices such as the ICE U.S. Dollar index, but its impact on actual physical trade flows is trivial.

If we glance across the other ocean, the largest story is not so much China's rise as an exporter to the U.S. but its displacement of other Asian exporters. Not only Japan but Korea, Taiwan and Hong Kong have seen their roles decline. Some countries are increasing in importance as customers of the U.S.; China is one of the fastest-growing, as is India.

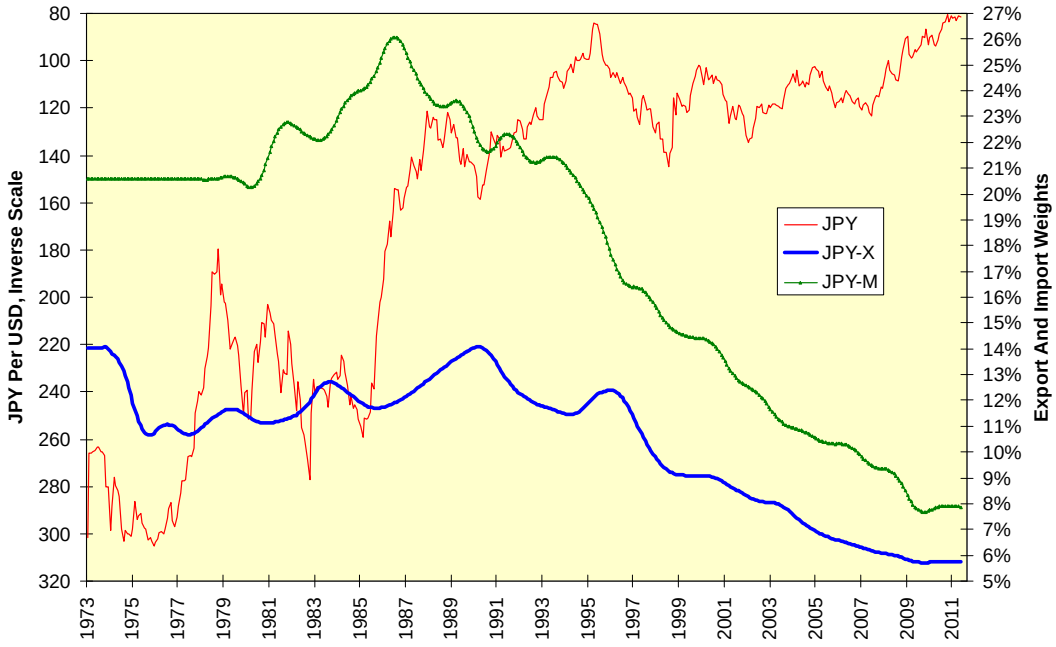
Let's take a look at the role of Japan and the Eurozone as examples. While the euro rose steadily between 2002 and 2008, export weights to the Eurozone rose slightly and import weights have remained fairly steady. The currency's erratic trade since 2008 has been met with a yawn by both import and export weights.

The Euro And Its Weight In U.S. Trade



The yen is a very different story. Import weights from Japan have been on a quarter-century decline regardless of whatever the yen has done. Export weights to Japan have fallen as well, not because of anything the yen has done but rather because Japan has been mired in a funk for its two Lost Decades.

The Japanese Yen And Its Weight In U.S. Trade



Will any of this matter to those who call constantly for a stronger yuan or some other currency movement to address our own economic problems? No, not at all: Why let facts get in the way?