

Trade, Currencies And Competitive Devaluation

The quote often is attributed to Mark Twain, and while some switch gears to Disraeli, the actual source is someone named [Leonard Courtney](#): “There are three kinds of lies: Lies, damned lies and statistics.”

I often lie awake at night wondering why I am forced to choose between three such attractive alternatives.

Regardless, assorted politicians, protectionists and misguided economists have been laying a whopper on all and sundry for years that a weaker currency leads to an improved current account balance. This conveniently ignores such realities as more than 90% currency trade is unrelated to underlying physical flows and that trade in large classes of goods such as petroleum, grain, high-technology and the military hardware so beloved by assorted thugs and warlords is unaffected by exchange rate variations. There is also something called the J-curve wherein the cost of imports rises after a currency declines and before trade flows adjust to the new price.

When exchange rates began to float, allegedly freely in theory but never freely in practice, more than forty years ago no one contemplated what would happen if all major trade powers decided to devalue their currencies competitively. The answer, now as it should have been contemplated then, is changes in currencies would have at best a trivial effect on the current account balance.

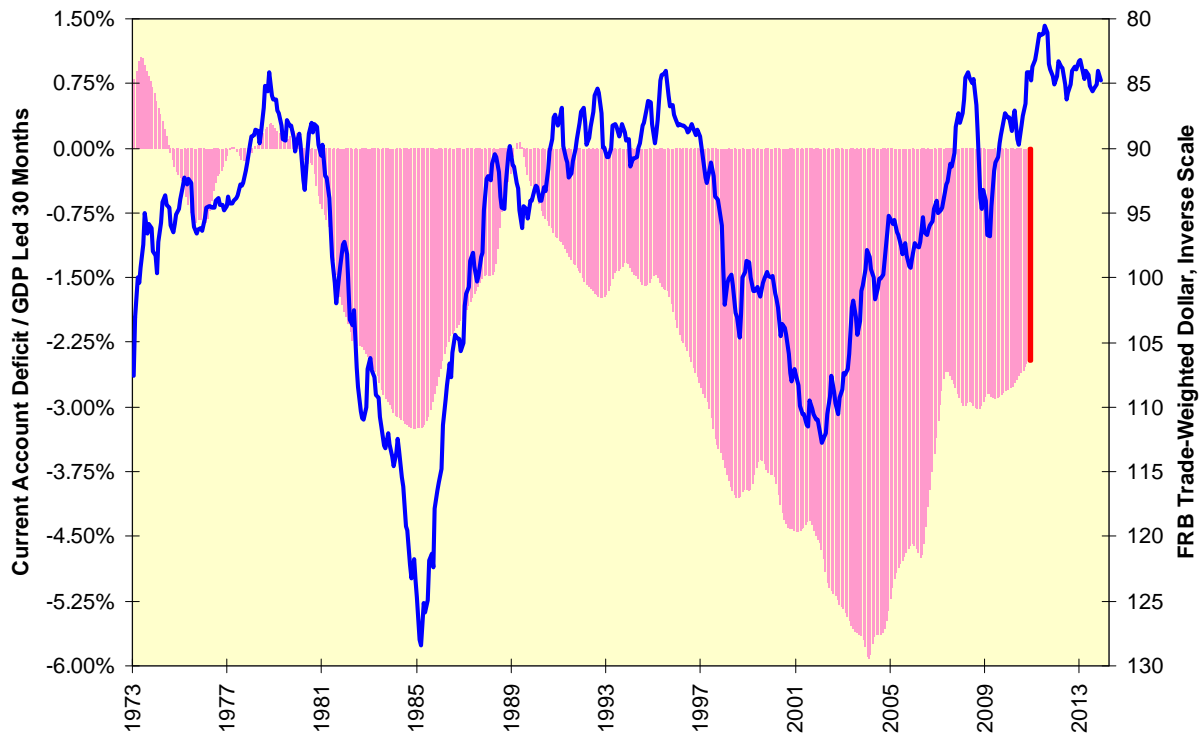
The Trade-Weighted Dollar

While the Marines are looking for a few good men, I am looking for a good dollar index. The standard for trading still remains the ICE U.S. Dollar index, which underlies futures and options as well as ETFs such as the PowerShares U.S. Dollar Index Bullish Fund (UUP) and, you guessed it, the U.S. Dollar Index Bearish Fund (UDN). The six currencies in this index have remained at fixed weights since 1973 even though trade patterns have changed dramatically over the past four decades. Explaining the Swedish krona's role in this index is about as rewarding as trying to justify daylight savings time.

Other indices are based on correlation-weighting schemes, financial flow schemes and in the case of at least one major business newspaper, hissy-fit schemes. The Federal Reserve, for its part, has a family of trade-weighted dollar indices, none of which are licensed for trading purposes; we would not want our central bank to lose its treasured independence, would we?

How has the U.S. current account balance as a percentage of GDP changed as a function of the trade-weighted dollar since 1973? The answer is very little; as a 30-month lagging function of the trade-weighted dollar the r^2 , or percentage of variance explained, is a mere 0.21. Restated, we still need to account for the other 79% in factors such as changing global income levels, technological and other factor-endowment shifts, labor force changes and, yes, everyone else's currency shifts.

Trade-Weighted Dollar And U.S. Current Account Balance



At least the effects in the chart above are directionally correct; a weaker trade-weighted dollar does lead a contraction in the current account deficit and vice-versa. If this pattern holds, we should start to see an end of the current account deficit's shrinkage by mid-2014. That will be a drag on GDP and no doubt will lead to a clamor for that other macroeconomic fiction, more monetary incontinence.

Is this a great business or what? To finish with an actual Will Rogers quote, "I don't make jokes. I just watch the government and report the facts."