

Currency Trade Weights Over Time

One of Milton Friedman's (and others') arguments for adopting floating exchange rates during the 1971-1973 period was they would lead to self-correcting trade deficits. The idea was a country in deficit would see its currency weaken, which would make its exports cheaper and imports more expensive and as my German friends would say, "Voila!"

After 37 years of failure, you would think this idea would be put on the junk heap. The concept may work for trade between two countries in undifferentiated goods with few intervening costs, such as auto parts across the U.S.-Canadian border, but it does a poor job in accommodating the inclusion of large new players, such as China, in international trade. Moreover, it ignored how exchange rates would tend to be set primarily by expected interest rate differentials and secondarily by prospective returns on assets and only in a minor way by actual trade flows.

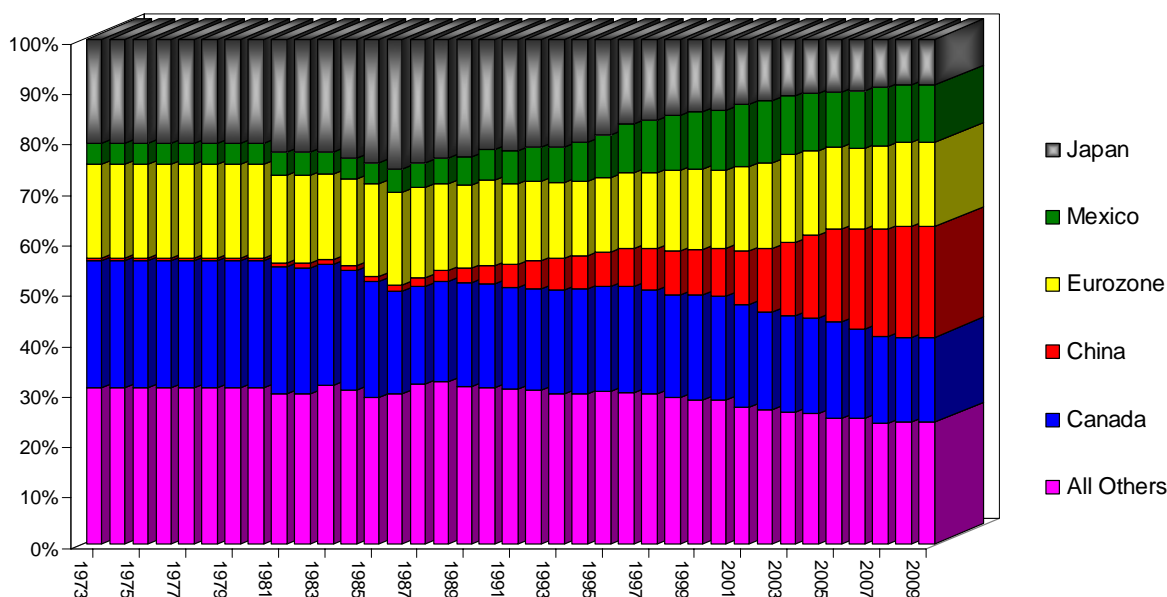
As an aside, both the late Milton Friedman and Robert Mundell, "the father of the euro," won Nobel Memorial Prizes from the Swedish Riksbank. Doctoral students in economics may take heart the rest of the world knows how to reward theory at the expense of reality.

Federal Reserve Trade Weights

The Federal Reserve maintains a number of trade-weighted dollar indices. These are not licensed for financial instruments, are updated only annually and with the speed we have come to expect from any official agency; the 2009 weights were released in mid-May of this year.

Their trends over time tell an interesting story. First, three-quarters of the import weights and two-thirds of the export weights derive from five sources: China, Canada, Mexico, Japan and the Eurozone; the others will be aggregated for visual clarity. Let's take a look at the imports first.

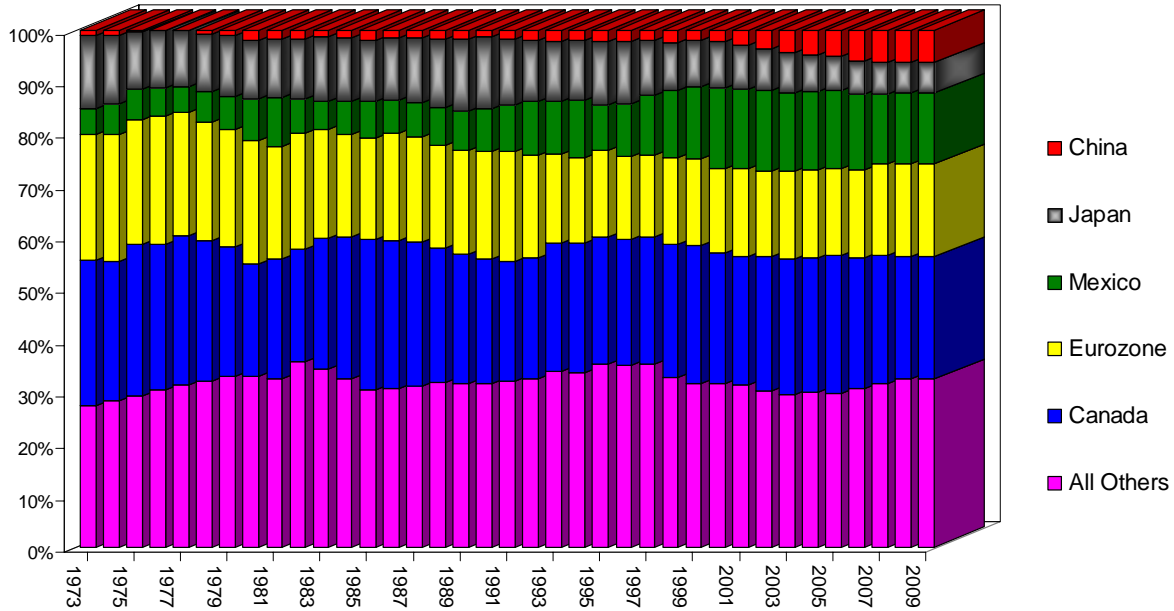
Total Import Weights For U.S. Dollar



The most prominent development over time has been the seizing of market share by China from Japan and Canada. Mexico's share expanded after the passage of NAFTA, but it has stagnated in recent years as *maquiladora* plants have become uncompetitive with Asian exports. In economic terms, Mexico now is exporting labor, a factor in production, as it has lost a competitive advantage in the production itself.

On the export side, China is displacing Japan as a customer of the U.S. Exports to both Mexico and Canada expanded after the passage of NAFTA, as have exports to "all-others;" this category includes important growing customers such as Brazil, India, the Middle East and the Asian periphery.

Total Export Weights For U.S. Dollar



What is or should be striking in the pictures above are the rather constant weights for the Eurozone. Given the euro's prominence for financial flows and for traders and given its outsized 57.6% weight in the dollar index, you might think all of the changes over the years in the rates between the dollar and the euro and its predecessors would lead to substantial changes in trade weights.

The U.S. and the Eurozone have structurally similar economies and factors of production. As a result, we trade in similar goods where differences in customer tastes and small quality differentials mean more than price. Moreover, much of the trade between the two zones is inter-subsidiary and represents a transfer. Finally, large physical traders who find themselves sandbagged by the dollar-euro rate have only themselves to blame: What market is easier to emplace a hedge?

Will any of this stop calls for official currency manipulation to redress current account imbalances? Absolutely not; we have 37 years of data to suggest the world's protectionists are better at making noise than in making sense.