The US rope trick, or how to keep the dollar up

The deficit is at a new high but the greenback defies gravity. Where's the logic?

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Burn the textbooks. Forget that fuddy-duddy stuff about demand and supply. Blow a raspberry at economic theory. That, apparently, is the message being sent out by the foreign exchange markets, where the dollar reached a two-year high against the euro and the yen last week.

But isn't it the case, I hear you ask, that the United States notched up a record trade deficit of $66.1bn last week - equivalent to 6% or so of its gross domestic product? Yes it is. And isn't the US financing that trade deficit by flooding the global markets with dollar-denominated assets that are snapped up by its creditors? Right again. And when the supply of something goes up, isn't it customary for the price to come down? Full marks for impeccable logic.

Even so, if you were using logic to play the forex markets in the past few weeks, you would have lost money. All sorts of reasons have been trotted out to explain why the dollar has been going up -none convincing. One of the more absurd theories was that investors have been dumping euros owing to to the low-level civil war in France; this doesn't explain why sterling fell against the greenback by a similar amount.

Nor is it convincing to argue that higher interest rates in the US than in the eurozone or Japan explain the appetite for dollars. To be sure, investors take into account prospective yields but they also have to factor in the risk of currency depreciation. And there has to be a risk - a whopping big risk, in fact - that at some point the world will have had a bellyful of a currency which, after all, stopped being backed by anything tangible back in 1971. It is worth noting that the recent strength of the dollar has been accompanied by a sharp rise in the price of gold; some investors, at least, are taking precautions, and they are quite right to do so.

When you get down to it, there are only two reasons for an appreciating dollar. One is that it is going up because it is going up; the herd mentality of markets means that you do what everybody else is doing even if you think they are wrong. The second is that the markets have deluded themselves into thinking that a country that is spending one dollar and six cents for every dollar that it is earning doesn't have a problem.

The fact that the Chinese, the Japanese and the other big exporting nations of Asia are colluding in this financial fantasy should come as no surprise. A strong dollar is wonderful for these countries since it helps them to build up their industrial - and, in China's case, political -power even as American manufacturing is hollowed out.

It would be misguided of the US to believe that all sides gain equally from this arrangement; the Asians are getting by far the better of the deal, owning enough US dollar assets to buy a controlling interest in every company listed on the Dow Jones Index. As a new book by Bill Bonner and Addison Wiggin (Empire of Debt: The Rise of an Epic Financial Crisis; published by John Wiley) notes: "They [the Asians] have enough Treasury bonds to destroy the US economy on a whim."

Imperial people

One day China may want to do just that, but not yet. For the time being, it does not have any incentive to halt a process that allows it to grow at three times the pace of the US economy, and is prepared to take the risk that the symbiotic relationship will fall apart. Whether it is in the interests of Americans to sit back and do nothing is another matter.

Bonner and Wiggins argue that the US can't stop itself. Drawing parallels with the last days of Rome, they argue that Americans believe they can go on spending more than they make indefinitely. "They go deeper and deeper in debt, believing they will never have to settle up. They buy houses and then mortgage them out, room by room, until they have almost nothing left. They invade foreign countries in the belief that they are spreading freedom and democracy, and depend on lending from communist China to pay for it. The imperial people choose to spend rather than to save, and to hallucinate, rather than think hard. They demand bread and circuses at home; let the Asians sweat abroad."

The question of whether Americans are now living on a far-flung outpost of cloud cuckoo land is explored a little less colourfully but with equal clout in a paper* written by Wynne Godley and three colleagues for the Levy Institute in upstate New York. This charts with brutal clarity the deterioration in the US trade balance and current account over the past 15 years, and projects that on current trends the trade deficit will be 7.5% of GDP by 2010.

When a country imports more than it exports, there is a hit to its growth rates. Between 1992 and 2001, the US managed to offset the impact of a widening trade gap on demand by a credit-financed consumer binge. Between 2001 and 2003, when the consumer briefly retrenched, the government stepped up to the plate with a huge fiscal stimulus that kept the economy going but only at the expense of a hefty budget deficit. From 2003 to now, consumers have again discovered the joys of borrowing as if there is no tomorrow, this time on the back of a housing market bubble.

With interest rates rising, and house prices in some parts of the US at unsustainable levels, Godley et al are right to bet on a period in which individuals will borrow less and save more. But in those circumstances, consumer retrenchment coupled with a whopping trade deficit would spell deep recession unless one of three things happened.

Firstly, the US government could take the strain again, widening the budget deficit to maintain demand. The Levy paper suggests the deficit would need to go to 8% of GDP to achieve this. Option one is therefore not likely.

Secondly, the Americans could take tough protectionist action to limit imports into the US, which would bring down the trade deficit even if - as would be likely - other countries retaliated.

Protectionism

This is the nuclear option, make no mistake, and Washington would undoubtedly prefer to see the trade deficit cut by rejigging currencies and rebalancing global demand. Indeed, it may use the threat of protectionism to seek a third way out of the current predicament. A longer-term solution to global imbalances through an international agreement in the spirit of the Bretton Woods post-war settlement seems just the ticket, with the Asians agreeing to boost domestic demand and revalue their currencies and the Americans agreeing to export more and consume less.

Let's not delude ourselves, it's not going to happen this side of an almighty crisis that brings everyone to their senses. At some point, as Bonner and Wiggin note, the shopkeeper who keeps extending credit to a customer having problems paying the bills in the hope that he will eventually straighten himself out can end up sharing the pain. Until the crunch comes, however, it's easy to keep believing the fantasy.

Dice don't cheat

Clearly, as the strength of the dollar shows, economic theory has its limitations, especially when human emotions get in the way.

One example is the experiment where one person makes a proposal to split a sum of money - say £10 - with a stranger. The stranger can be offered anything from 10 pence to £9.90: if he or she accepts, the pair split the money as agreed; if not, they both get nothing.

Simple economic theory says the person making the offer should suggest keeping £9.90, leaving 10 pence for the other guy. That way the person making the split "maximises his utility" but both parties are better off. In reality, it doesn't work like that. Many real people would rather walk away with nothing than be treated inequitably. They would think it well worth giving up 10p to deprive some greedball of £9.90.

A study in this month's Economic Journal shows that people are much more prepared to accept inequitable outcomes when the means of arriving at them is seen as fair. Researchers from Germany, Spain and the US took away the right of one of the participants to name the terms of the bargain, substituting a roll of the dice. Support for an inequitable split rose from 19% to 41%.

According to the researchers, this has wider implications: it suggests that even the losers from economic policies that promote efficiency at the expense of equity will come to accept the outcome provided they were given an equal chance.

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* The United States and Her Creditors: Can the Symbiosis Last?; Wynne Godley, Dimitri Papadimitriou, Claudio Dos Santos, Gennaro Zezza. dbp@levy.org.