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MACROCOSM

Trade Deficit Hokum

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Don't believe the scare stories about the record trade deficit -- it's a sign that the US economy is recovering.

In a new outbreak of hand-wringing over the trade deficit and its supposedly alarming effect on the dollar's foreign exchange value, the far-from-dramatic reality is no match for the clatter of headline-grabbing sound-bites. "Dollar Hits 2-Year Low Against Euro," declares the headline on the front page of today's *New York Times* business section. True enough, but what that report -- or any other that I'm aware of -- neglects to mention is that the last time the euro traded in a range around \$.96 in mid-2000, the U.S. economy was in the last lap of its powerful decade-long expansion.

By that point the relentless and ultimately destructive appreciation in the dollar's real purchasing power had already seen the European common currency fall from the \$1.15 levels at its inception at the beginning of that year. By the same token, the broader G-6 trade-weighted dollar index has now declined by about 9% since hitting close-to15-year highs early this year. But at an index value around 108, the trade-weighted dollar is currently at a level first crossed in the first half of 2000 after rising nearly 20% over the previous 18 months or so. This recent history is important to bear in mind in the face of overheated warnings about a dollar "crash" in the making. Relief from the dollar's most deflationary levels does not by any stretch of the imagination equate with a risk of dollar collapse.

As for the "record" trade deficit recorded in April, at \$35.9 billion it was only about \$1 billion higher than the previous record reached in September 2000. At that time, the rising negative balance on the trade accounts was widely -- and correctly -- seen as reflecting the US economy outpacing its global partners, and drawing in foreign portfolio capital seeking the highest returns available in the global market. To a significant extent, then, this increase in the deficit also suggests that despite the economy's thus-far uneven pace of recovery, the US is still outperforming its industrialized-world competitors.

How is it that a rising deficit -- which was consistent throughout the 1990s with the dollar's appreciation -- suddenly threatens a dollar blowout? It doesn't. In fact, as a discrete element in the matrix of factors determining the dollar's value, the sustained capital inflows which are associated with a growing current account deficit are actually dollar-positive. That's because **the Fed**, like most central banks, "sterilizes" the inflows. That is, to the extent conversion of foreign currency-originated investment funds results in an increase in dollar balances, the Fed as a matter of operational routine drains those balances from the US financial system. Ostensibly the procedure is intended to guard against an inflationary liquidity excess developing as a consequence of rising capital inflows. During the latter half of the 1990s, though, the practical effect was to increase the scarcity of dollars as the Fed failed to accommodate the increased foreign-based demand for the US unit of account. Over time, a self-sustaining dynamic developed, as the dollar's rising value contributed to increased foreign investment flows, which the Fed was duty-bound to sterilize, further increasing the dollar's value.

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But for now at least, whatever dollar-strengthening forces might otherwise be at work are more than offset by the Fed's domestic liquidity stance. The latest data published by the **St. Louis Fed** shows that over the four-week period ended June 12, adjusted reserves grew at an annual rate of more than 20% from the period ending April 17. Maintaining a 1.75% Fed funds rate is compelling the Fed to operate a more generous open-market posture than it has in years. Obviously, as well, a significant speculative element has entered dollar trading in recent days, which is apt to happen in an environment roiled by such media and public agitation. At the margin, the dollar's abrupt decline has no doubt also factored into the equity market sell-off, as foreign holders of US assets protect themselves against the risk of further currency-related losses. At some point in the not-too-distant-future, though, that tide could well shift, as new cheaper levels for the dollar create bargains in the eyes of foreign-based investors. TM