

World Trade 2010

In the latter part of 2008, the value of world trade plummeted as availability of trade finance evaporated at the same time that global economic growth slowed drastically. 2008 saw a reversal of globalization as the developed world consumer retrenched after a protracted period of operating too low a savings rate accumulating unsustainable levels of debt. The emergency measures taken by governments to reflate their economies be it in monetary or fiscal policy has sent nominal GDP rebounding with a more moderate impact on real GDP. This caused a recovery in world trade, albeit not to pre crisis levels. The inventory cycle led by lagged destocking and restocking led to a magnified response in industrial production and world trade. The cyclical nature of a lagged transmission mechanism had already manifested in the middle of 2009 where world trade faltered again. November 2009 saw further weakness in world trade. This is further evidence that the developed world economy's recovery is yet fragile. Additionally, the situation in trade finance is still difficult. Bank lending remains frozen. Unless banks can find additional capital or capital relief under Basel II, they will not be deploying capital.

And yet, one should not be too quick to lose heart. A lagged transmission system creates oscillations around a recovery path. The current recovery path is interesting. The balance of trade between the US and China is a good proxy, given the volume of trade between these two countries. Since 2001, the trade balance has evolved into a US deficit cyclically correcting but trending well into deficit. The current cycle has seen a sharp correction towards balance as the crisis took hold in 2008. The recovery in 2009 saw a resumption of the US deficit but not to pre crisis magnitudes. The deficit appears to have stopped growing and appears to be in the process of

drifting towards balance. As the US trends towards a net exporting position the conclusions for interest rates, the USD and inflation are most interesting.



FX transaction volumes are dominated by speculative and financial activity. Asset-liability share of FX transaction volumes are in the minority, 20% to 25% is an estimate provided by several FX hedge funds. Yet speculative transactions impact on FX tends to add volatility and not drift to the process whereas trade driven transactions tend to introduce drift. The implications are therefore for a strong USD.

There is another factor impacting the USD and that is that as world trade recovers from the doldrums, demand for USD as a trading currency increases. This is especially true from inter emerging market trade which is more likely to settle in USD. Inter developed market trade will sometimes settle in USD but is more likely to settle in the vendor country's currency. Countries with closed capital accounts, capital controls, currency risk, and political risk will almost exclusively trade in USD.

Macro conditions are stacked therefore towards USD strength and not weakness. At the time of writing, this is a contrarian view.

Extending this thread, a strong USD worsens the terms of trade for the US potentially countering the drift in the trade balance. If the US is to drift towards a neutral trade balance, and the lack of vendor financing certainly pushes in this direction, internal pricing must adjust where external pricing cannot, suggesting deflation.

I have long argued without success or conviction that interest rates were too low to be efficient, that a low interest rate

encouraged over investment as the hurdle rate for putting capital in harm's way was too low. My argument lacked conviction because with a central bank setting short rates, it was hard to tell what a hypothetical market rate of interest would be...

A naturally strong USD affords the Fed latitude in keeping policy looser for longer. A deflationary environment is likely to keep long term interest rates lower as well.

Where does that lead? Monetary policy that is chronically loose has implications for dollar peg countries. If China does not yet have an asset bubble, it will. But it could take some time. And one can always watch in disbelief and disapproval from the sidelines, for quite a long time.