



Global Views

Goodman on Currency and the Carry Trade...

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How much is that Dollar in the Window? Or, a Case against more Quantitative Easing

As the U.S. economy continues to stagger, the role of the (formerly?) almighty dollar is of paramount importance. Nobody knows what will happen as a result of the two rounds of quantitative easing the U.S. has instituted. And now with jobs numbers and growth sputtering there is sure to be a push for a third round. It's completely unprecedented. Well, not exactly. Let me try that again. There is, in fact, at least one glaring precedent. The same thing has happened to Japan over the last twenty years. And if America ignores what happened to the yen and the stalling of the Japanese economy, it will do so at its own peril. So let's take a brief look at the story of the yen and then all its chilling similarities to the current day dollar.

The Ghost of Carry Trades Past

Way back in ancient history (approximately 2007) the Fed Funds rate was at 5.25 percent. At the same time, the Bank of Japan kept their interest rates as close to zero percent as they could manage. Now combine that with a relatively stable exchange rate and it's a license to print money. Just borrow yen, at zero, and lend dollars at 5.75%. That's the carry trade.

Traders considered the carry trade as close to a sure thing as money can buy. As a result the trade became leveraged to the extreme. How leveraged was it? Well, some accounts have as much as one trillion, with a T, dollars tied up in the trade when the credit crisis hit. A quick look at some exchange rates makes the same point in graphical form.

On the next page you can see how the dollar performed against a handful of currencies in 2008. The first graph shows, as would be expected during a credit crunch, the dollar becoming more expensive in most of the world as it became much harder to come by. But now look at the dollar in relation to the yen in the second graph. Yen flowed back in a torrent to Japan as the decimation of the bank balance sheets and forced deleveraging required an unwind of the carry trade. It's a stark contrast and one that was woefully underreported at the time.

Yogi Berra the Prophet

Now let's fast forward to the present. As the great Yankee catcher once said, "A nickel ain't worth a dime anymore." In case you didn't notice, our fiscal policy kind of looks Japanese. Interest rates are being held at zero, and two rounds of quantitative easing have

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greatly increased the money supply. Dollars are ripe for borrowing, which of course is the point of QE. In an ideal world people borrow money, invest it in the economy and we all win. But this is not an ideal world at all. So instead of the borrowed dollars being invested in the American economy and being put to good ol' red, white, and blue work, those dollars face the possibility of going elsewhere. It's a double whammy. When the economy was humming, America was borrowing yen low and investing domestically. Now, as we desperately struggle to jump start our struggling economy, not only do we not have yen to borrow to help finance it but we may not even have all of our vastly increased supply of American dollars.

Show Me the Money

So, if we run the risk of dollars leaving the economy, where does it all go? In Japan's case, it was famously invested in the New Zealand dollar and the Australian dollar which had distinctly high interest rates. Today, one likely place seems to be commodities. It's certainly reasonable to believe that a dollar carry trade is at least a partial contributor to the meteoric rise in gold, silver (even taking into account its rough last few months), oil, and grain. Another possible place to look would be the BRIC countries and emerging markets in general. That's right, our hard earned dollars at work in Brazil, Russian, India and China.

So, what's the take away? I say that it is time to begin the process of limiting the money supply again, and raising interest rates. If that can't be done maybe I should just move to Brazil. On second thought, leave those interest rates exactly where they are...

