THE FABLE of the “FEARFUL” DEFICITS

For about 40 years, economists have been scaring investors and business leaders with the fable of the triple deficits, namely the Trade Deficit, the Current Account Deficit, and the Budget Deficit. They fabricated such convoluted economic connections of cause and effect between these deficits, which now even members of the economic establishment reject.

When the dollar is rising, as it did from 1995 to early 2002, economists don’t say much about these topics. After all, it doesn’t fit their story. But as soon as the dollar declines, even if it is from the very lofty levels of 2002, they immediately warn of Armageddon because of the ‘triple deficits.’

My advice to investors: forget about it. It’s economic nonsense. Of course, some economists will disagree strongly with what I write here. That’s ok. Disagreement is the foundation of all debates, and productive changes.

THE U.S. DOLLAR: FEAR STORIES

On November 19, Fed Chairman Greenspan basically declared a weak dollar policy, without directly saying so. He warned in a talk in Europe that “*the insatiable foreign demand for dollar holdings would eventually fall as investors diversity…We see only limited indications that the large U.S. current account deficit is meeting financing resistance. Yet, net claims against residents of the United States cannot continue to increase forever in international portfolios at their recent pace…It seems persuasive that, given the size of the U. S. current account deficit, a diminished appetite for adding to the dollar balances must occur at some point.”*

Dr. G. said that a current account deficit over 5% of GDP is “unsustainable.” Well, with all due respect, I humbly disagree. One has very little to do with the other. It’s like saying that the number of houses, or cars, as a percent of GDP is unsustainable. You can’t base economic or investment policy on such convoluted thinking.

However, Dr. G.’s statements were carefully designed to send a signal that Washington wanted a weaker dollar. He basically said that foreigners should sell dollars. Currency traders obeyed him and promptly sold the next day. Over the following week, the dollar hit new multi-year lows almost on a daily basis. Currency traders are simple creatures for the most part: they just follow the herd.

Over the years I have met many currency traders. I even attended a conference one time with over 2000 currency traders from all over the world. I was astonished to learn that they use basically no analysis for their trading. One trader just said, “we sell short when the currency goes down, and buy it when it goes up.”

NO DOLLAR FREEFALL!

The media makes everyone believe that the dollar is in a freefall. But the decline has been confined to some of the major currencies. Business Week wrote in a recent issue that the dollar has declined about 25% against major currencies of countries which account for 46% of U.S. trade volume.

However, against the currencies of what the Fed calls "Other Important Trading Partners (OITP)," the dollar HAS GAINED 5%. These countries make up 40% of U. S. trade.

Therefore, the weakness of the dollar has been greatly exaggerated.

Everyone believes the fairy tale told to us by economists, namely that the dollar is declining because of the **growing trade deficit, current account deficit, and the budget deficit**. Incredibly, the media in all its variations, propagate this story.

But the fact is that **there is absolutely no correlation with these deficits and the trend of the dollar. Sometimes, for several years the dollar strengthens even while these deficits are growing, such as from 1995 to 2002. And other times the dollar declines, even while the deficits diminish. The correlation is about as valid as between rain and washing your car.**

However, economists can't be swayed by the facts: they always must have something to warn about. Otherwise, they wouldn't be able to justify their salaries.

The fairy tale that the savings of foreigners are needed to finance our lifestyles cannot be supported by the evidence. Economists say we are beholden to the "kindness of strangers." They say we are importing over 80% of the world's savings to pay for our excessive consumption. What nonsense! Should we stop going to the stores and crawl back into caves?

One well-known Wall Street economist recently predicted 'Armageddon' for the U.S. economy. He sees the chances of avoiding this and muddling through as "one in ten." Wow! Head for the bunkers!

He said that America has to import $2.6 billion in cash every working day to "finance" its current account deficit. That sounds like a lot, but it's about 5% of the size of our economy. But the term "finance" is totally misplaced. The current account is nothing ore than an accounting entry. It's not a car, or home, that needs to be financed.

Even more important is that this money (the deficit) originated in the U. S. With that money, we bought goods abroad, or had computers, electronics, etc. manufactured abroad, much of it by U. S. companies. We send the money abroad and get the goods. Then the foreigners send us back our money, in the form of **investments**. THAT'S A GREAT DEAL! They invest the money in the U.S. is real estate, manufacturing plants, buying U. S. firms, or just plain old U.S. bonds.

Don't economists see the benefit of this? Well, they look at money flows into and out of the U.S. When more money flows in then flows out, they call it an "imbalance." They call this excess inflow a "loan" from foreigners. Never mind that this money may be **investment** flows, to build a factory for Mercedes or Toyota, or build new hotels or office buildings. Economists simply say that we "owe" this money to foreigners. Apparently, economists don't have to take a course in accounting.

Well, if they want to say that we "owe" this investment capital, then the foreigners "owe" us their U.S. factories, office buildings, hotels, and other investments they have made in the U.S. However, the owners of these assets would certainly object to that.

Assuming that the value of these investments has probably appreciated over the years, while the dollars may not have, then the value of what they "owe" us is much more than the dollars we "owe" them. That would be called "a surplus," totally contrary to what economists tell us.

I often read economists saying that **"these huge imbalances have existed for several decades and must be corrected."** And you guessed it, only economists can correct them, not the hundreds of millions of people in the market place.

Well, any imbalance that has existed for several decades is not an "imbalance," by definition. I would call it a great "balance." If you stand on the ledge on top of the Empire State building all day long, you are in balance. When a gust of wind pushes you of, and you start to fall, you are out of balance for a second or so. When you crash on the sidewalk, you are once again in balance. In other words, imbalances can only last for a very short time before forces correct them. And we don't need economists to do that.

How would economists correct these alleged imbalances? They would force U.S. saving higher by curbing consumer spending. This would reduce imports and thus hopefully reduce the trade deficit. The resulting weakened economy would be a disincentive for foreign investment capital, thereby reducing the current account deficit. And economists would be very happy.

However, the rest of us, i.e. 295 million people minus 10,000 economists, would be miserable as we would find ourselves in a juicy recession, soaring unemployment, massive debt defaults, a stock market and real estate crash, and possibly a depression.

The rest of the world wouldn't like it any better. The diminished U.S. consumer demand would produce a world wide recession and a similar tidal wave in economies around the world.

And what would have been accomplished? Nothing except that some totally irrelevant numbers look better in the eyes of some economists.

It is a fact that countries with the weakest economies, the highest unemployment, and weakest currencies also have the highest trade surpluses. That's logical, because they are too poor to buy any product from abroad.

Does anyone still want to "improve" our current account deficit?

The **trade deficit** is just as irrelevant. It just measures how much we buy from foreigners and how much they buy from us. The problem with the numbers is that each country counts them differently. Some count the cost with freight while others don't, they may or may not include custom duties, etc. About 15 years ago, it was acknowledged that the trade deficit could be wrong buy about $100 billion dollars per year. Now that error could be 50% or 100% greater. Could it be that maybe we don't have a trade deficit at all?

But it doesn't matter, because it's not important. If we just look at the U.S., can you imagine the trade deficit Nevada has with California? Nevada buys a huge amount of goods, especially food, from California. What does California buy from Nevada? Not much. But does anyone worry about Nevada's trade deficit with California? No!

Californians take these accumulated dollars and gamble them away in Nevada. This may produce a "current account deficit" in Nevada as money is imported into Nevada. Economists would say that Nevada is "borrowing" the savings of the Californians. Horrors! They may say that some day, Californians may decide to stop lending to finance the lifestyles of the Nevadans. I can just see all the people in Las Vegas staying up at night worrying about this.

What about the **federal budget deficit**? As a percent of the total assets held by the Federal government, it's a drop in the bucket. As a percent of total GDP, it's a cup of water in the bucket. When you travel the beautiful freeways in the U.S., or visit the gorgeous national parks, you can appreciate the wealth of this country.

The freeways are worth billions, and a very valuable business asset. Without them, Americans would spend millions of hours more traveling to and from work, or doing their work, while delivery firms like Fedex would have to charge double or triple, thus handicapping businesses. Yet, these valuable assets are never mentioned by economists. They only refer to the investment it took to create these assets, and call it the "national debt."

Well, looking only at the debt, without looking at the value of the assets, is the height of stupidity. Yet, you never hear anyone question this. The media parrots the debt numbers as if they really meant something. Isn't accounting a mandatory requirement for getting an economics degree?

The accumulated federal deficit is about 10% of the value of all the assets held by the government. That's not much.

Economists never stop telling us that our **savings rate** is dismally low. Yet, contrary to many other nations, our savings statistics do not include pensions. Other countries count this. If we count savings the same way, we are not doing badly.

Economists don't tell us that the **savings of corporations in the U.S. has risen to the highest rate in several decades**. It would destroy their case for a gloomy future, which of course requires economists to come to the rescue.

Do economists have the answers? Evidence suggests the contrary. Do you remember the well-publicized **NAIRU theory of employment**? In the 1990's this well-accepted theory said that the unemployment rate could not go below 6% without increasing inflation significantly. I called the theory "hogwash" and wrote that unemployment could go to 4% without producing inflation.

Well, in 1999 the unemployment rate not only got below 6%, but below 4%, and inflation continued to decline. Yet economists for several years urged the Fed to tighten money, in order to slow the economy, and thus to keep the unemployment rate above 6%. Fortunately, Dr. G did not pay attention to the NAIRU theory.

The recent dollar decline had nothing to do with the "deficits." It was a policy induced by Washington in order to stimulate the U.S. economy, to fight deflationary pressures, and make the U.S. a great place for foreigners to shop and invest. The dollar chart shows clearly that the decline in the dollar started in early 2002. This was at the time that our WELLINGTON LETTER was headlined: *"REFLATION BRINGS GREAT OPPORTUNITIES."*

The vice-chairman of the Fed had declared that deflation could be fought through various means, including a cheaper dollar. And that's what they did. The decline did nothing more than erase the rise in the dollar which occurred from 1995 to 2002.

The dollar decline makes the U.S. very attractive to foreigners. All assets in the U.S. are now about 30% cheaper than in early 2002. Can you imagine, a German or Japanese investor can now buy U.S. real estate, stocks, bonds, and other assets at a 30% discount? That's attractive.

Foreign travelers can now come to the U.S. and probably vacation here cheaper than it would cost them to stay at home.

Of course, I expect economists will warn, as they did in the late 1980's, that all these investments by foreigners is dangerous as eventually they will own all the important assets in the U.S. At the time we called that "economic nonsense."

The assets bought by foreigners in the late 1980's eventually were sold by them at distress prices in the 1990's. Properties were sold at 70%-90% less than the foreigners had paid.

The original U.S. sellers of the assets, and later those who re-bought them, are the ones who got the bargains.

Conclusion: Hundred's of millions of people in the market place are much better at producing "balances" than a truckload of economists. The market place produces adjustments automatically. Interference with the market is what causes tremendous distortions.

We should not listen to the dire warnings of economists. The legendary fund manager, Peter Lynch, wrote in his first book, that if as an investor you spent more than 10 minutes per week looking at the economy, you are wasting your time.

I have a rule that when the economic establishment pulls out these old tales of gloom and doom, they really have run out of actual problems to discuss. It's a sign that they are scraping the bottom of the barrel for scare stories.

There is never a time when the country, or the world, doesn't face some problems. Let's just separate the real ones from those which are artificially created in people's minds.

Bert Dohmen, President
Dohmen Capital Holdings Inc.

(Subscribe to Bert Dohmen's WELLINGTON LETTER today and get the full story, with specific "What To Do" recommendations, including charts to prove the case. Go to: www.dohmencapital.com.)

Note: If you would like to profit from the great opportunities immediately ahead with Bert Dohmen, go to our website www.dohmencapital.com. Here you will find services for short-term traders, as well as for long-term investors.

Subscribe today. You'll be glad you did! www.dohmencapital.com/ordernow.htm

ORDER NOW