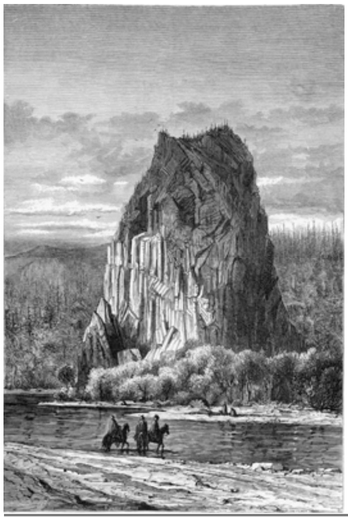

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Central Bank Intervention a 21st Century Version of Smoot-Hawley Tariff?

The meeting of the Asia-Pacific Economic Cooperation (APEC) group in Singapore may provide an opportunity to reflect on the direction that the U.S. Administration is now taking in international relations and economic affairs. Despite talk of a strong U.S. dollar by Treasury Secretary Timothy Geithner during his trip to Asia, as well as President Barrack Obama's comments while in China, events surrounding APEC may be instructive for understanding the potential for the further currency devaluation, a slower global economic recovery, and higher gold prices.

In the recent economic crisis, central banks have accommodated government stimulus programs to increase liquidity and avoid a financial catastrophe. As the crisis recedes, central banks have accordingly attempted to reign in excess liquidity and achieve currency stability and resume economic growth. The Federal Reserve Bank appears less optimistic about growth, unconcerned about inflation, and continues to maintain easy money policies. Interestingly, domestic economic policy within the U.S. appears designed to accommodate a change of national priorities willingly contrary to currency stability and determined to drive down the U.S. dollar.

The decline has complicated trade by nations seeking recovery and economic growth by resuming exports against the headwind of a falling U.S. dollar. As markets seek equilibrium, nations prevented from a return to economic stability may have no choice but to protect their domestic economic interests by pursuing protectionist activities or devaluing their own currency. This suggests higher gold prices from a global perspective, not only the in the U.S., as easy money policies in the U.S. are exported to the world.

First Shots of a Trade War Likely Blanks

Sniping between the U.S. and China over trade following the recent economic crisis appears to be transitioning from talk into action, including increased duties. Like causes of and reasons for most wars, the discontent is widespread and mutual. Fortunately, the number of sectors impacted, or total level of trade impacted, is relatively minor compared to U.S.-China trade in the aggregate.

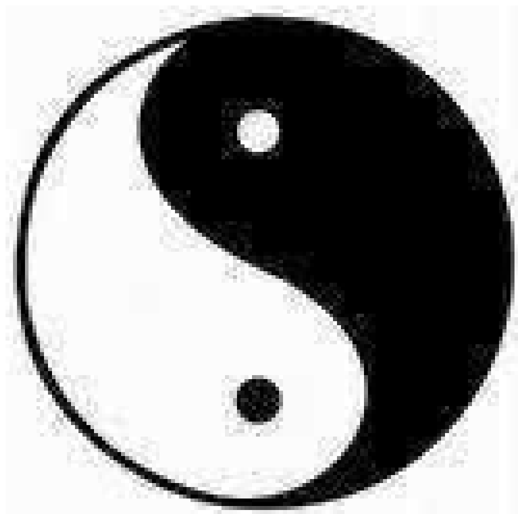
As trade has liberalized over the decades and nations are increasingly dependent on export, any trend toward protectionism is reminiscent of actions leading to the Smoot-Hawley Tariff Act of 1930 that contributed to both the depth and length of the Great Depression. While significant parallels come to mind in comparing the current financial downturn with the Great Depression, it could be that growing international agitation may be more a dysfunctional form of diplomacy, laying out new boundaries and alliances, rather than taking a match to institutionalized global free trade.

Nations dependent on exports recognize protectionism as the nuclear option. Accordingly, they rely on their central banks to intervene and support the U.S. dollar to maintain currency stability and maintain the competitiveness of their exports. Intervention may be successful in the short-run as a global arbitrage strategy, but it is compromised if a dominant currency, the U.S. dollar in the present situation, is bent on a path of devaluation as a means to either reduce domestic consumption or increase exports. Foreign central banks contemplating intervention are faced with a devil's choice of buying increasingly worthless currencies or devaluing their own currency in order to boost their exports.

The Yin-Yang Relationship of U.S.-China Relations

The situation becomes problematic for developing nations dependent on exports to the U.S. when China, a dominant world exporter, has pegged their currency to the U.S. dollar. China has succeeded in setting up and accommodating a falling U.S. dollar by its capacity to absorb large quantities of U.S. Treasuries. The U.S. has benefited by purchasing cheaper goods and effectively exporting its inflation to China. By fixing its currency to the U.S. dollar, and enjoying a comparative advantage for low operating costs, Chinese goods become more competitive in U.S. markets, basically closing other nation's exports out. This hybrid form of protectionism, not universally as destructive as the Smoot-Hawley Tariff Act, may certainly appear so from the perspective of other non-Chinese exporting nations.

China has become equally more significant in world affairs and the U.S. has become equally less significant. The U.S. and China seem to be approaching a yin-yang relationship at the exclusion of others in the world economy. The yin-yang relationship is a balance of opposites contained within a dynamic setting. China is successfully moving from a communist system while absorbing positive classic-liberal economic attributes of capitalism. Conversely, the U.S. is moving unsuccessfully from a functioning capitalist system to the anemic form of European socialism. China has successfully combined a lassie-faire economic approach with a uniquely American Protestant work ethic, while in the U.S., politicians and academia are attempting a "Great Leap" backward assuaged by consumerism and a sense of entitlement that is simply lazy. For the time being, the yin-yang relationship will hold as long as these two nations "complete each other." While the yin-yang characterization of U.S.-China relations is a snapshot of a balanced relationship, statements made by both Secretary Geithner and President Obama suggest that the present situation cannot be sustained indefinitely.



U.S. Prestige and Economic Policy Pales Under International Scrutiny

The yin-yang model appears to explain the previously harmonious U.S.-China relations, but Secretary Geithner's comments as stated in his letter to the Wall Street Journal (November 12, 2009; A-23), reveal the yin-yang of his own thinking that is out of balance with the reality of economics and international relations. He appears to be seeking a balance of "partnership of common interests to produce strong growth" and "open markets" but warns other nations to "spur greater growth of private demand in their own economies." In other words, nations wishing to export cheaply produced goods should buy their goods themselves. He later explains that this is because "U.S. households [will] save more and the U.S. reduces its fiscal deficit." U.S. households may expect to have less disposable income available to consume fewer goods as they will be paying higher taxes in years to come. Interestingly, the devaluation of the U.S. dollar increases the cost of imports, which is an indirect form of taxation on U.S. consumers.

Comments in the letter by Secretary Geithner included statements that appear at odds with reality or the direction of U.S. domestic policies. He seemed to lecture other nations on the "importance of strong financial regulation and fiscal balance," but this is strange coming from a U.S. treasury official. Additionally, he suggested that durable growth would emerge from "flexible labor markets" yet this doesn't fit with the preference shown to union-workers by federal intervention in auto industry, card check legislation, and a high minimum wage. He offered a suggestion that "economies must strengthen health and retirement benefit schemes, thus reducing the need for high precautionary saving that contributes to global imbalances." This statement suggests that wealth accumulation in the U.S. is at the root of the problem and that redistribution of wealth in the U.S. would be part of international "rebalancing."

President Obama's trip to Asia is highly significant and imperial, but the town hall format seems to be growing tired. Asian nations, including China, are looking for direction and are growing impatient as they hope the U.S. takes action to stop the decline of the U.S. dollar. President Obama's priorities are managing global climate change and the reduction of nuclear weapon proliferation, albeit unilaterally, by the self-emasculating Cap and Trade legislation and disarmament. As the U.S. steps out on the ice, other nations may be whispering, "You go first."

In the yin-yang dynamic, some characteristics will remain opposites. President Obama's suggestion of a more open Internet in China seems to be a non-starter. The simplicity of the yin-yang reality is that some things will never mix. Even the suggestion, while not attending the anniversary of the Berlin Wall, creates more questions than answers regarding his Wilsonian view of cooperation among nations. In any event, once the show in Asia draws to a close, it is unlikely that the direction of the U.S. economy will remain unchanged.

President Obama, with characteristic optimism befitting the Monroe Doctrine, projects a positive vision of international cooperation. While APEC was clearly not the level of a League of Nations, it was important for investors to take note of Asian nations seeking to reduce bubbles forming in their own economies due to devaluation of the U.S. dollar and abandonment by investors. President Obama can't be blamed for hoping for a breakthrough moment, but most of the world outside of Washington simply wants to get back to work and earn a wage in a currency it can trust.

The Dow and Other Bubbles From Loose Money

Monetary easing by the Fed has certainly brought a smile to Wall Street, but this has not trickled down to the rest of the U.S. The Fed remains clearly focused on employment numbers as its primary support for maintaining near zero interest rates. There appears to be growing consensus among Fed presidents, economists, and business that a recovery is being pushed further into the future. While some unemployment is slowing, new jobs or business creation remains scarce. Banks remain skittish and are bracing themselves against either additional write downs or Congressional meddling and intrusion. Congress anxious for a quick fix looks eager to propose additional stimulus programs or a rehashed Community Reinvestment Act. Higher taxes from the lifting of the Bush tax cuts and from health-care reform appear certain. Stabilizing of corporate earnings are due more to cost cutting than to increasing revenues. It is becoming increasingly difficult to believe that markets are forward looking.

A stagnant U.S. economy is reason enough for monetary easing, which should lead to further dollar devaluation and higher gold prices. Should other nations be unable to stimulate domestic spending, the loss of markets from the devaluation of the U.S. dollar will have functionally the same impact as a tariff, with potentially disastrous consequences for both developing and developed nations alike. They too may be forced to resume monetary easing to protect their own domestic export constituency, which may increase the supply of currency world-wide and lift gold prices from most any perspective.

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