Mitchell's Musings 11-7-11: Current Events and Currency Burdens

Daniel J.B. Mitchell

From the New York Times comes this story about Japanese policy to weaken the yen against the dollar:

*...The strong yen is a **burden** for Japan as it seeks a path to recovery after natural and nuclear disasters this year. While companies have been quick to rebuild factories and restore supply chains, the yen has undermined revival for the nation's exporters, which drive much of its economic growth, by making their products less competitive overseas...*

Full article at http://www.nytimes.com/2011/11/01/business/global/japanese-officials-intervene-to-weaken-yen.html

And the headline on the article reads "Japan Acts Alone to Weaken Its Currency" (underline added).

Now the yen/dollar ratio is the reciprocal of the dollar/yen ratio. So it must follow that a strong dollar is a burden for the U.S. as it seeks a path to recovery. That simple arithmetic, however, seems to have been lost when it comes to the U.S. and its policy on trade and exchange rates. Why is it legitimate for Japan to act unilaterally ("alone") in setting its exchange rate but not the U.S.?

You might think that Japan was running down its international reserves as a result of the tsunami-nuclear disaster. But you would be wrong; Japan has over a trillion dollars in international reserve assets – nothing much has changed on that front since before the disaster. A trillion dollars might seem like a lot but it is roughly a third of the accumulation amassed by China – a country which also acts unilaterally regarding its exchange rate.

As prior musings have noted, the U.S. could stimulate its economy to the tune of 3-4% of GDP simply by closing its net export deficit. And, in fact, to work off its debt to the rest of the world, the U.S. needs to run an export surplus.

- - - -

And while we are on the subject of currencies and such, here is another excerpt from a news item – this one from the Santa Monica Mirror, a newspaper given out for free in my home town:

The three major national credit rating agencies, Fitch Rating, Moody's Investor Service, and Standard & Poor all affirmed the City of Santa Monica's triple-A credit ratings this week. A credit rating of triple-A is the highest credit rating the agencies assign. Santa Monica's strong fiscal management, low debt levels and diverse economy, is behind the rating, according to the City…

Full story at http://www.smmirror.com/#mode=single&view=33324

Readers will recall last summer's flap when one of the credit rating agencies downgraded U.S. Treasury securities below triple-A. Now Santa Monica, a city of around 90,000 people, is definitely affluent and has a solid tax base. Despite its reputation in the past as a leftist "Peoples Republic of Santa Monica," the local authorities have always taken pride in its triple-A rating. But seriously, Santa Monica bonds more secure than U.S. Treasuries? The federal government can create dollars and its securities are promises to pay in what it can create. Santa Monica has to earn its dollars to repay its debts; it can't create them. To the extent that China and Japan are holding dollar reserves, you can rest assured that none of their holdings are in Santa Monica bonds.

The slogan on the City seal translates as *happy people in a happy city*. We are indeed happy about our town having a triple-A rating. But we are not silly about it. The failure of institutions of finance – which include ratings agencies – to think rationally about monetary matters is also a burden on the recovery of the U.S. economy.

- - - -

And then there is Greece. After negotiating a "rescue" plan to avoid default, Greece announced it would hold a referendum on whether to implement the rescue – which Greek voters might well reject because of the austerity entailed. Later, there seemed to be uncertainty about the referendum idea on the part of the Greek government and then the idea seemed to fade. Let's put aside the question of whether the rescue plan was well designed or whether the euro-zone countries are helping or hurting their own recovery with their various policies. Here is a quote from an article about the issue, again from the New York Times, on the proposed referendum when it seemed to be a live prospect:

"If Greek citizens decide to vote against it, it would be very difficult for the Greeks to stay in the euro zone," Ms. Möller said. "Maybe this is the most elegant way of leaving the euro zone, not members kicking out a country but the Greeks choosing, through democracy and with legitimacy to leave."...

Full story at http://www.nytimes.com/2011/11/02/world/europe/markets-tumble-as-greece-plans-referendum-on-latest-europe-aid-deal.html

You have probably seen any number of such stories, which involve Greece defaulting in some way – referendum or not - and exiting the euro. What none of these off-hand comments explain is exactly how Greece could exit the euro. Greece gave up its drachma currency to be part of the euro-zone. Would it just print up some new drachmas and toss them in the street? Would it demand that its population turn it the euros it has been holding for new drachmas at some arbitrary exchange rate? I hate to think of the popular response. Would it attempt to pay off its creditors in new drachmas? It's relatively easy to give up a currency, but not so easy to create (or re-create) one. Even Santa Monica - with its triple-A rating - might have a problem if it decided to issue "monicas" in place of dollars. The possibility of a renewed financial crisis based on the European Greek/euro dilemma remains.

In short, the only thing for sure about the Greek/euro currency crisis is that it threatens to be a burden on the U.S. recovery. As such, it is in good company with the aloofness of U.S. trade and currency policy and with silly bond ratings.