

The Perfect Stimulus???

September 2009

Something has been nagging me for quite some time. Inflation hawks are out there suggesting the Fed's monetary policy is going to drive us into a Zimbabwe situation. The debt implosion bears suggest deflation will remain rampant in our economy for quite some time. Will it be Zimbabwe, Argentina, Japan, all of the above or something else over the next decade or so? Needless to say all this seems to have many of us uncertain of what to do, with our money, our careers, our lifestyles and our families.

It appears we currently have significant over capacity in our consumer economy. My last Armchair piece, "Back to the Future", brought to light the massive retail over capacity we seem to have in the U.S. If American's can't consume like we had become addicted to, then we have way too many retail stores. If we have way too many retail stores then we have over capacity in consumer products, transportation, warehousing, media and advertising and everything that supports our consumer economy. Oh, and by the way, we seem to have over capacity in homes and homebuilding, too.

Certainly we have asset deflation. That seems obvious. Home values have collapsed over the last three years, except it seems in my Houston neighborhood where tax authorities just jacked up my valuation again. But with less consumption, asset values in all parts of the consumer economy equation have to go down. This currently has commercial real estate investors, owners and lenders staring into the abyss. And tons of small businesses all over the country have seen massive revenue contraction this year. Lower revenues certainly mean lower take home pay, but also lower business valuations. Asset deflation seems alive and growing. Wall Street might be "fixed" but Main Street still seems to be struggling.

To combat asset deflation and the corresponding economic pain, Washington has executed a "shock and awe" (June Armchair) fiscal and monetary strategy. There is ample debate over whether this "shock and awe" will inspire an improving economy. Plenty of people are grasping at every green shoot (May Armchair) that seems to emerge while the doom and gloomers continue preaching future destruction inspired by loose monetary and fiscal policy. Is there any light at the end of this very dark tunnel of economic conundrums (July Armchair)?

Maybe we have overlooked a major economic stimulus opportunity still available, one that would not cost our taxpayers a single penny. It would not require or inspire government bloat. It has the potential to put money in our pockets with little to no pain and suffering. Why hasn't anyone yet figured this one out? Maybe because the herd instinct has everyone looking in the wrong direction, maybe because there is no way to actually set policy that inspires this type of activity, or maybe I'm just a jelly headed Armchair economist.

1971 was the birth year of this potential stimulus, executed by one of the most maligned Presidents in U.S. history, Richard Nixon. Although loathed by many, Nixon may have been one of our shrewdest Presidents. After thinking through this circumstance, one might even argue that Nixon had a great deal of responsibility for our prosperity boom the last 30 years. You might even argue that Nixon's actions set the stage for America to win the Cold War. Have I got your curiosity up?

In 1971 Nixon decoupled the dollar from gold. Now if you talk to a gold bug, they will tell you this is the event that eventually dooms America. Without gold behind any currency gold bugs suggest it is

Armchair Economic Perspective
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only a matter of time before managers of that currency print and spend themselves into inflation and economic oblivion. Not personally sure of this impending doom the focus of these thoughts will instead be on an opportunity Nixon's 1971 action may now provide America.

You see we went off the gold standard right about the time Americans were buying more and more things from our trading partners. Soldiers came home from WWII to get married, buy homes and launch a baby boom. Japan, Germany and European economies had been building post WWII economic momentum with American consumers in the leadership role. In the early 1970's we saw Toyoda (the way it was first spelled) and Volkswagen start gaining momentum in U.S. sales penetration. And we all know that Japan was selling us radios, then TV's, cameras, stereo equipment and other electronics by the boatload.

By removing the U.S. from the gold standard, whether consciously or not, Nixon put us on the path to making the dollar the world's reserve currency. As we bought more and more imports, we exported more and more dollars. The dollar has been our greatest export for quite some time.

Today everyone seems to think the world is awash in dollars. Many people fear this puts the U.S. in a very weak position, concerned that at any moment China, Japan and others will start a selling landslide in their dollar positions. But is this view realistic? If China is going to sell their dollars, their U.S. Treasuries, who is going to be the buyer? From what I can tell most everyone around the world thinks they already have too many dollars. So where is this massive buyer going to emerge to take out this potential massive seller?

Gold bugs would suggest the shiny metal could explode in value, 2, 3 even 4 times today's price. While certainly a rapid conversion of dollars to gold can cause such escalation, is it practical for that to happen? It would seem catastrophic to the global economic system. How would trade be conducted without a currency? What worthwhile country wants to commit economic suicide?

Maybe these dollar holders are stuck. John Connally, former Secretary of the Treasury, supposedly once said, "The dollar is our currency...and your problem." Should this be the case it seems only three things can happen.

- The dollar will continue to grow as the world's reserve currency.
- Dollar holders will diversify their currency position very slowly.
- Dollars return to the U.S...to buy U.S. assets.

The dollars around the world keep moving around the world. And so as long as the U.S. continues to have a trade deficit, we will continue to "export" more dollars, which keeps them growing in the world's pockets. If the Chinese use their dollars to buy some Brazilian oil then the Brazilians now have those dollars. If the Brazilians use those dollars to buy a bunch of French wine then the French have those dollars. Those dollars will remain constant at best. They will more likely grow as the U.S. continues to import more than we export, as we give out more dollars than we take in. This keeps the dollar growing as the world's reserve currency.

An alternative currency is the dollar bears' problem. There are very few currency markets broad and deep enough to replace the dollar. Most of the Euro's strength over the last couple of years likely

Armchair Economic Perspective
The Perfect Stimulus???
September 2009

comes from the desire for currency diversification rather than the belief Europe's economy is in better shape than the U.S. But the Euro seems to have peaked.

What can a currency owner in search of diversification do? Slowly over time, currency holders can diversify into smaller float currencies that might seem a safe harbor. The Norwegian Nok, Australian Dollar, Canadian Dollar and Chilean Peso seem to fit that mold. All have held up pretty well lately. Notice they can be considered "commodity currencies". (For another Armchair down the road.) But even these alternatives are still not enough to replace the dollar as the world's reserve currency. There are just too many dollars out there and not enough alternatives.

So what happens if those dollars are brought "home", back to the U.S.? If the Chinese or other foreigners buy domestic U.S. assets then it props up our asset values and puts money in our pockets. It also removes those dollars from the global market, which strengthens the dollar by lowering global dollar supply. In a related positive development, a stronger dollar will keep the price of oil low, reducing the threat of commodity induced inflation.

There are certainly repercussions to this strategy. The U.S. is loath to sell our national treasures, but why not let foreigners buy some of our less treasured. One man's garbage can be another man's treasure...and many times that other man can create new value from it.

If we were more open to selling our "assets" to the Chinese and other global holders of dollars, then we would get some new liquidity. And new liquidity would be economically stimulating. That stimulus would not require raising taxes, borrowing more money or cranking up the monetary printing press. Feeling a bit richer we Americans may just go back to consuming a little more. And who is going to benefit from that? The Chinese, as they are manufacturers for the world. Hey hey! This sounds like a win-win! What does it cost us if foreigners buy our assets? Nothing. It puts money in our pockets.

Conscious or not, going off the gold standard was an amazingly cunning strategy. It shoved the dollar down the throats of the world. Now the world is awash in dollars. The only way they can really get rid of those dollars is by buying U.S. assets. Buy our assets and get rid of your dollars. That puts dollars in our pocket. Don't buy our assets and the dollar's position, as the world's reserve currency grows stronger by the day. Seems like a nifty strategy here. Maybe there was more than one reason to call him Tricky Dick.

This Armchair Economist doesn't have all the answers, but certainly wants to find them. Tossing out crazy ideas is something you can do from the Armchair. There's no downside to being laughed at by faculty peers or competitors for that top job on Wall Street. I'm just ranting and raving away with the hope that maybe once in a while this possibly blind pig might smell out a little acorn.

Sell something to the Chinese! That's a stimulus our grandkids don't have to pay back.



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