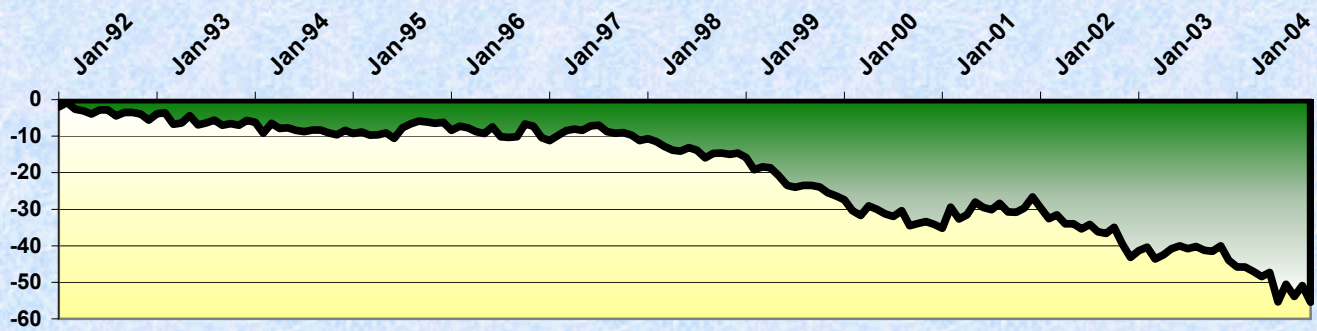


December 2004 Commentary

Balance of Trade: Goods & Services (\$billion per month)



Rising Trade Deficit and Sinking U.S. Dollar - Blame it on China?

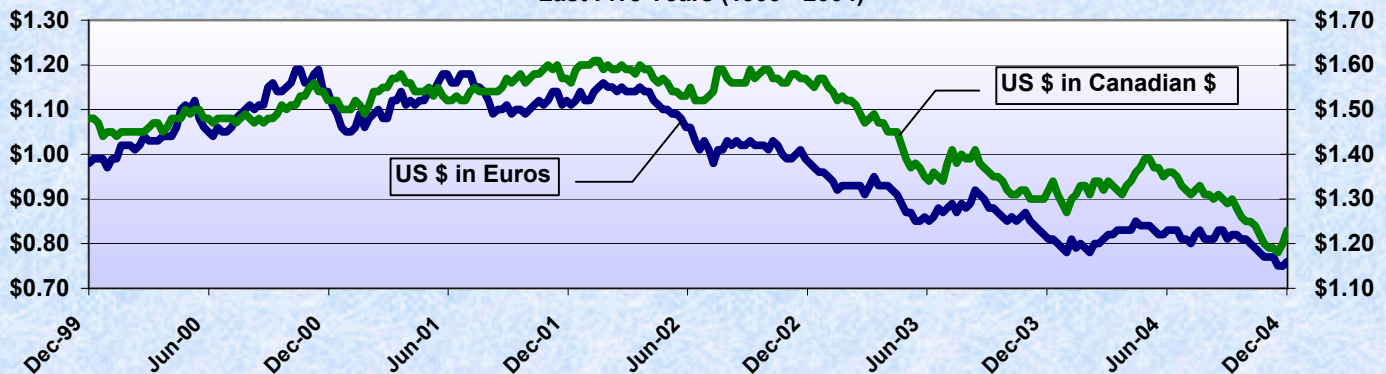
Over the last decade our trade deficit has been deepening and recently the value of the dollar as compared to many key currencies has been falling. Why is this occurring and how long might it last? The answer: It depends on China.

In the first ten months of 2004, the United States has imported about \$500 billion more than we have exported (see chart above). It's not just oil. While about \$150 billion of the total is crude oil, natural gas and other petroleum related products, the remaining \$350 billion is spread across a wide variety of products (automobiles -\$100B, clothing & footwear -\$70B, televisions & VCRs -\$55B, office machines -\$53B, furniture & bedding -\$19B, toys, games & sporting goods -\$15B and other goods -\$38B.) The only real products which the U.S. carries a significant trade surplus are airplanes & airplane parts +\$20B and cotton, corn, soybeans and wheat +\$17B. In almost every other category the U.S. has a trade deficit or marginal surplus.

Our trade deficit is expanding for two reasons. First, it's driven by demand. U.S. consumers demand new computers, furnishings, toys, etc. and consume significant amounts of energy products. Many of these products are available more cheaply overseas or, in the case of oil, must be purchased from foreign producers (by the way, the U.S. has purchased just as much crude oil from each of Canada and Mexico this year as from the two biggest OPEC producers, Saudi Arabia and Venezuela; a total of about \$15B from each country). The second reason for the expanding trade deficit is weak demand for U.S. made goods and services abroad. Many foreign economies have been growing at slower rates than in the U.S. and up until recently the high U.S. dollar made U.S. produced goods expensive when compared to alternatives (see chart below - from its peak the U.S. dollar is down 35% in Euros and down 25% versus the Canadian dollar).

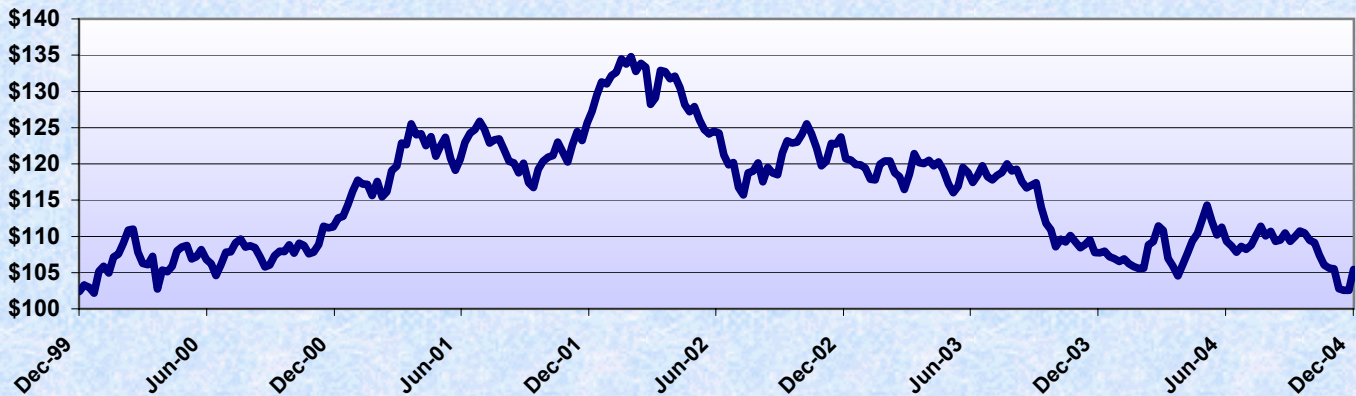
"Finance is the art of passing currency from hand to hand until it finally disappears." - Robert W. Sarnoff

US \$ in Euros and Canadian \$
Last Five Years (1999 - 2004)



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US \$ in Japanese Yen - Last Five Years (1999 - 2004)



Currently the U.S. carries a trade deficit with almost all major countries in the World. The largest trading partner for the U.S. is Canada. In the first ten months of this year \$370 billion of goods and services have traded hands, and so far this year the U.S. has purchased about \$55 billion more than it's sold to Canada. This is causing the Canadian dollar to appreciate relative to the U.S. dollar and may ultimately help to shrink the trade deficit with Canada (as U.S. goods and services become more attractively priced in Canadian dollar terms). The trade deficit with Canada ranks third largest and only our deficits with Japan and China are larger.

With Japan, in the first ten months of 2004, the U.S. imported \$106 billion and exported \$45 billion, resulting in a \$61 billion trade deficit. In the last three years, the Japanese Yen has appreciated versus the U.S. dollar, but the Yen is only back to the same level of five years ago (see chart above).

The country who holds the largest trade deficit with the U.S. is China, with a whopping \$131 billion deficit this year, and growing. In the first ten months of this year we have exported a total of \$28 billion to China, up \$7 billion from this time last year, but we have imported a total of \$159 billion, up \$34 billion from 2003. Currently, China has a fixed exchange rate with the U.S. (see chart below). This fixed exchange rate is making Chinese made products very competitive in the world marketplace, to the detriment of U.S. and European producers. The U.S. and European governments are placing pressure on China to let its currency float (the assumption is that once China lets its currency float it will rise, making Chinese made products less competitive), but until China relents our trade deficit will likely continue to expand. This also means that our currency will likely continue to sink versus the Euro, Canadian dollar, the Yen and many other currencies, at least until U.S. interest rates reach an attractive enough level to entice foreign holders of dollars to keep their dollars invested here.

The bright side of the sliding U.S. dollar is a pick-up in foreign tourism. Goods priced in U.S. dollars are now more attractive to many Europeans and many are making special visits to the U.S. just to go on spending sprees! So next time you see a French or German tourist, be sure to thank them for spending their Euros here.

"My dog is worried about the economy because Alpo is up to 99 cents a can. That's almost \$7.00 in dog money." - Joe Weinstein

US \$ in Chinese Yuan - Last Five Years (1999 - 2004)

