New Minerva Report

J-Curve

In the last few weeks we have seen a string of economic numbers reports, many of which have surprised. We have also seen markets waiting anxiously for some numbers, especially in the US. We have had three notable GDP announcements which have surprised in both directions. In the UK, economic growth showed a positive surprise, with fourth quarter initial estimates of 0.7%, which made annual growth of 3.1% for 2004. We had been told that in China the economy was being successfully slowed by the government, growth came in at 9.5%, compared with 9.1% in the third quarter. Also surprisingly, inflation eased in December to 2.4% for the year.

Finally, the US GDP growth for the fourth quarter slowed down to an annualised rate of 3.1%. Expectations had been for a slowdown from the 4% of the previous quarter, but it was only down to 3.5%. The main reason for the slowdown was the balance of trade deficit. Readers may recall that exports minus imports, are a component of the GDP (economic growth) total. So if imports are greater than exports, this reduces GDP growth (see November 2003 for GDP formula). We had already had a warning of how big this negative figure was going to be when the November trade deficit was reported at a record $60.3bn. The widening deficit was created by imports growing by 9.1%, while exports fell by 3.9%. This took 1.7% from GDP growth. Looking at the US alone, domestic demand was at a very strong 4.7%. Therein lies the problems facing the world economy. The US is consuming above its means. We saw some jitters enter the markets after the trade deficit numbers. Those being a record, markets asked whether the US economy would have sufficient inflows of money to offset the deficit. In the event it did. In November foreign investment into the US rose to $81bn, up from the $48.3bn the month before. There is little doubt that both the October and November figures were hit by the US election. October's figure was lower because of the uncertainty, and November's higher once that uncertainty had gone.

There is an historical precedent to what we are now witnessing in the US. Back in the 1980s, the US started to have a trade deficit. From 1985, the dollar started to fall. This, it was suggested, would solve the deficit problem. As the dollar fell, this worsened the trade deficit, because the figures were being translated back into a dollar which was falling (the J-curve effect). As we entered 1987, the dollar stabilised as the Federal Reserve raised interest rates. The J-Curve effect could no longer be seen as the reason for a deteriorating trade deficit. Then it was realised that a falling dollar was not the answer to the trade deficit. Bond prices started to fall, thus yields rose. The final outcome was that bond yields became too attractive to professional US investors, and they switched from equities. This was the trigger for the Autumn 1987 share price collapse.

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