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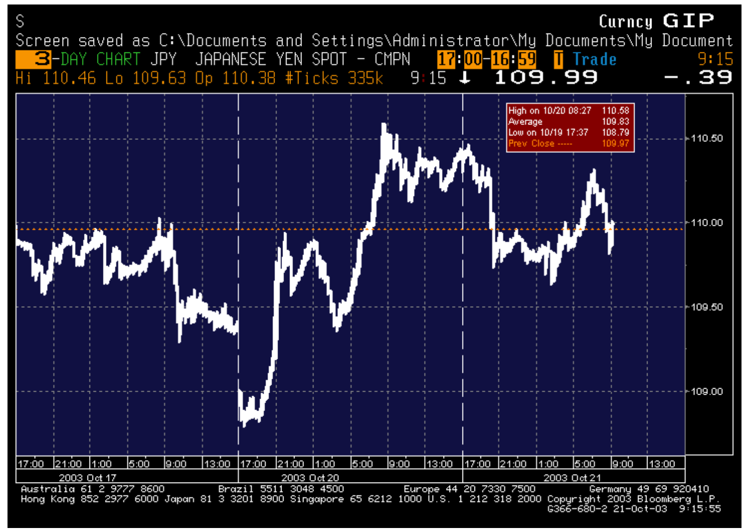
Cerberus and Snow: playing for time



US 10 Year Bond October 19/20 **Japanese Yen October 17-20**

The U.S. has a three-headed policy dog:

- Current account deficit
- The interest rate "bubble"
- The worsening government deficit

?? One method of attacking the U.S. trade deficit is to correct the dollar bubble that occurred from 1995 to QI2002, thereby restraining imports and stimulating exports. To do that, other major trading nations' currencies have to revalue against the dollar, and many of these countries are reluctant to see their currencies rise while confronting domestic economic weakness.

?? U.S. economic growth prospects have improved markedly, calling into question the ability and willingness of the Fed to keep the Federal Funds rate tethered at its currently low level. The Fed, however, may have boxed itself in with its continued stress on a "for a considerable period" mantra initially designed to reassure markets against deflation. Does the Fed now have an "exit strategy?"

?? A combination of poor economic growth, the need for fiscal stimulus and Congressional unwillingness to trim expenditures, has the U.S. budget swirling into a very large deficit, and that deficit is likely to worsen if pre-election politics produce a substantial increase in health care benefits.

Weak Dollar or Strong Dollar: take your pick

One of the 12 tasks assigned to Hercules was to bring Cerberus, the three-headed dog guarding Hades, to the surface of the earth. It appears Secretary of the Treasury Snow has been assigned some equivalent

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Herculean tasks in wrestling the U.S. policy Cerberus to the ground. Despite a recent denial by Snow that the U.S. doesn't have a policy to "weaken the dollar" and the President's reiteration of a "strong dollar policy" at APEC, it seems clear to most observers that the Dubai meeting of the G-7 and Snow's comments thereafter signaled currency markets that the dollar should fall absolutely against major trading partners. The continued attack on the FX intervention policies of trade partners suggests the U.S. has attempted to recruit the market to accomplish its policy goals. It may be true that the Administration is ideologically committed to flexible exchange rates, but right now, by recruiting markets to do the work, Snow-boning may be able to bring the dollar down without U.S. Treasury intervention in FX markets. The President recently tried to make a distinction between a "strong dollar policy" and a weaker dollar by citing intervention as the differentiating criterion. This is the FX policy equivalent of 'eating your cake and having it too!' This is a time-bound policy in an Administration playing for time.

This is a two-edged sword. One edge attempts to blunt political critics that focus on job loss allegedly stemming from the rapid growth in U.S. imports and barriers posed by a strong dollar on U.S. exports. The other is the U.S. desire to see foreign economic growth based on internal demand growth rather than export-led growth that creates political problems in the U.S.

The Asian dollar-block countries have mounted their economic revival on the back of their strong export surge, largely to the U.S. (and often originating with U.S. companies who have relocated manufacturing facilities to Asia). The current demon is China, but Japan is not far off-stage. Export-led growth policies have deep roots in both developing and developed countries. U.S. consumers surely benefit, but it may add to the speed of decline in U.S. manufacturing. The political potency of a trade sector imbalance arises because voters tend to vote based upon where and how they earn their incomes and less upon opportunities to spend that income on cheaper imports.

The China Syndrome is also two edged because an undervalued Yuan (RMB) creates incentives for U.S. manufacturers to relocate to China, ostensibly improving the profitability of major U.S. companies while accelerating the downsizing of American manufacturing. In election terms, this may not be good political arithmetic because it stimulates protectionist pressures and underlines the charge that the Administration is powerless on the job loss issue. Turning the RMB into a floating currency is thought to be a viable route to RMB appreciation, but de-stabilizing China, with its admittedly weak internal financial structure, is not a U.S. desire. Therefore, post-Dubai, Snow seems to be saying that the U.S. doesn't have a "weak dollar policy," but still leaves the ultimate revaluation of the RMB on the table. A joint study group, now agreed to between the U.S. and China at the APEC meeting, may partially arm the Administration against criticism that it is not doing enough to save jobs, but it is unlikely to push the Chinese into a near term revaluation (either by a widening of the peg or an outright float). The Administration wants to get by November 2004, so it beats the drum but not too loudly.

One lesson of the Asian Crisis of 1997 that gets repeated emphasis is that moving to a floating exchange rate regime without appropriate strengthening of internal financial markets puts the currency vigilante's on the trail of weak domestic financial institutions. Many have argued that China's large currency surplus is largely the effect of 'globalization,' and that an internal financial shock coupled with a totally free capital market, could potentially subject China to its own version of the Asian Crisis. China avoided much of the capital exodus of 1997/1998 largely because its capital controls don't permit unfettered outbound capital movements. Furthermore, China's trade accounts are not nearly as unbalanced as is its Current Account, and the large surpluses may represent unsustainably large capital inflows financing foreign domestic investment.

Using exchange rate policies to solve domestic problems may raise as many problems as they solve. An ironic consequence of a successful policy of dollar weakening would be to accelerate U.S. demand growth, just when it appears that the economy is finally into a high growth mode. Dollar weakening in reference to China, in the absence of a financial shock, would give their monetary authorities additional control over an economy that may be overheating. Greenspan pointed to this earlier this year as a source of policy change in China. In the case of Japan, however, there is a fear that a stronger Yen/Dollar rate could threaten its nascent recovery. The business cycle in each country cannot just be ignored. It is part of the policy process, and that means that the monetary/fiscal mix is always on the table. Each country is playing for time, a strategy with which this Administration is quite familiar.

The Second Head--Exit for the Fed?

Despite Greenspan's early warning on the RMB to Congress, the Fed has stayed out of public view on U.S. FX policy. That is its wont, but that does not mean the Fed is not a part of the policy process. Many have speculated that a market-induced weakening of the dollar puts pressure on countries with weak domestic economies to be much more stimulative. Translated to the EU, this means pressure on the ECB. So far, this has not resulted in any massive rate-cutting policy in the EU, but it is not inconsistent with pressure to reflate there either. The upward turn of the U.S. economy, however, has pointed to the very low short term interest rates that Fed easing has produced. Moreover, with QIII GDP set to have a big rise (5-7%?), the "for a considerable period" mantra of the Fed is now open to question. The problem faced by the Fed is how to tighten when necessary and pre-emptively having already committed to a considerable period of low interest rates. If the deflation bogeyman has really been defeated, it is natural to speculate on the timing of a tightening, and even more, on the language that will be used in not too distant FOMC meetings. Nearly any change in the language of the FOMC statement will set off expectations of sooner and more severe tightening, even if the Fed's plan is to let the economy run above its trend growth rate for a "considerable period" to reduce slack.

Now comes the Treasury Secretary in his- well-noted commentary in the Times of London today.[1] In an article by Anatole Kaletsky, Snow is quoted as saying "I would be frustrated and concerned" if there were not some upward movement (in rates.)" Further, the article suggests that the Administration is preparing for a sequence of interest rate hikes **even during the election campaign of 2004**, contrary to many Wall Street forecasts. He reportedly called the "Fed never raises interest rates before a presidential election" a mythology. It almost seems like payback time with Snow giving Greenspan cover to exit the current monetary policy regime, much as Greenspan pointed to the Yuan's peg as an unstable arrangement thereby giving a platform for Snow to do his dance in Dubai. Further, by allowing that "interest rates are the "price of capital," Snow focused on the current growth of the U.S. economy and his prediction that employment was ready to expand significantly. Employment expansion is the ***sine qua non*** of a change in Fed policy.

It is hard to believe that an "exclusive interview" in the Times was not purposive and that Snow, while not telling the Fed to change policy, was offering them much needed cover for an exit. It is widely reported that the search for an exit policy is very active at the Fed, and further support can be gleaned from the speeches last week of Poole and Parry. Maybe Coach Greenspan has the playbook afterall?

Growth as a Budget Policy Exit?

This Administration has a game-clock on its policy perspectives—November 2004. The third head of the

[1] Anatole Kaletsky, "US interest rates 'to rise soon'" **Timesonline** at http://www.timesonline.co.uk/article/0..5-861031.html.

policy dog is the expanding budget deficit that is widely criticized even by those who are not playing class war politics. The combination of little control on spending (at both Federal and State/Local levels), tax cuts and the War in Iraq, are producing a long-term problem of fiscal discipline. Ultimately, the fear is that lack of fiscal discipline will have both domestic and foreign implications. On the domestic side, it is the fear of "crowding out," while on the foreign side, it is the fear of "opting out" by Central Banks who now hold copious quantities of U.S. Treasuries. Added to that, there will be a crunch on possible expenditures when the cost of financing the deficit rises along with interest rate hikes. Growth will produce some relief, but by most estimators of longer term budget trends, even running at trend or slightly higher than trend growth, it will be hard to bring the budget deficit down substantially over the next decade. The deficit will get worse if promises by both sides of substantial increases in health benefits are added to the current Guns and Butter problem.

The Democrats have staked out a claim to raising taxes (on the "rich," of course) and will no doubt try to hold financing of the War in Iraq as a hostage to their policy goals. Snow's interview's seems to delineate the Administration's new effort: use economic growth and play for time. Snow is laying out the groundwork of an interest rate rise in the context of a successful recovery as a way to get past the fourth quarter of 2004. After that, who knows? Growth certainly won't hurt efforts to reduce the deficit because good growth will raise tax revenues at all levels. The Administration can then point to rising tax revenues and still push for to trim other expenditures as it seeks to collar the third head of its policy Cerberus.

After a long period, the Administration has found a spokesman that will try to move the markets in a direction congenial to Administration policies. If he can collar this dog for November 2004, this Administration will regard his efforts as truly Herculean.

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