TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Forex Folly

Monday, October 13, 2003

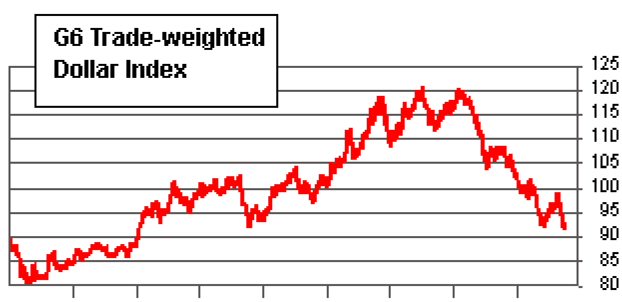
David Gitlitz

Stubborn inflation risks point to the dangers of the administration's currency gambit.

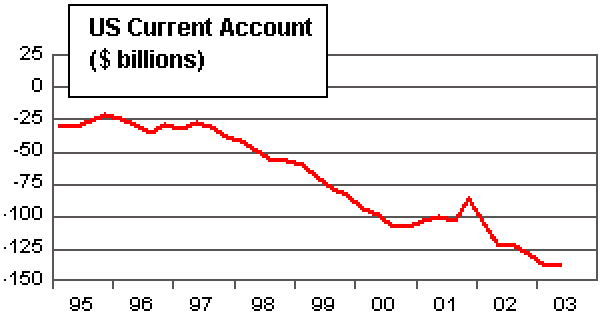
Last week we welcomed the job growth recorded in September as helping to relieve the risk of **the Fed** staying too easy for too long and stumbling into an inflationary overshoot in a misguided effort to guard against further "disinflation" (see "Back from the Inflationary Brink" October 6, 2003). That relief was most vividly captured by spot gold falling some $14 per ounce on the positive employment news, and was reaffirmed Thursday when better-than-expected jobless claims data precipitated another gold selloff.

Still, though inflation risks have cooled some on signs that an emerging labor market upturn will mollify our central bankers, they have not entirely been quelled. Apart from those two sessions in which gold was driven down by good job news, gold has exhibited considerable volatility in a range mostly above $370 -- a level which has not been sustained for any significant period in nearly seven years.

Nor is gold alone in indicating a degree of persistent inflation risk. While bond yields remain at levels nearly unthinkably low by the standards of the past 35 years, long-term Treasuries have been in a period of stunning volatility. Just since early last month, yields on the 10-year note have fallen from a better-than-one-year high of 4.6% to below 4%, before reversing course again and popping back above 4.25%. And these neck-snapping moves are only partially explained by uncertainties affecting Fed rate-hike expectations due to the changing outlook for job creation. Since the benchmark yield hit its recent low of 3.93% on October 1, fully 60% of the 32 basis point backup is attributable to rising inflation expectations, as captured by the spread between the nominal 10-year Treasury and its inflation-indexed (TIPS) counterpart. While at below 2.2% the TIPS spread is hardly discounting for a major inflationary outbreak, the abrupt widening does indicate that the market is opting, at the margin, for some degree of inflation-protection insurance.



Even as the risk eases that the Fed's commitment to remaining accommodative "for a considerable period" will produce monetary error, the market's continued inflation wariness is the inescapable consequence of the confusion over currency policy set off by **the Treasury's** Dubai gambit last month (see "Dangerous Game" September 23, 2003). To date, the threat posed by that ill-advised ploy is not being manifest in direct advocacy of a weaker dollar by the **Bush administration**. Rather, the damage caused by the Dubai **G7** communiqué is seen in the reinvigorated speculation it has touched off in the media and the markets suggesting either that the dollar's forex value is at risk, or that it must purposely be brought lower, in order to "correct" America's "massive" current account deficit.



Somehow, the myth that the current account deficit is a problem that must inevitably yield to the solution of currency depreciation remains impervious to a mountain of empirical, not to mention logical, refutation. In the second half of the 1990s, for example, the trade deficit grew by a factor of five, while the dollar's trade-weighted forex value soared by some 40%. Since early last year, meanwhile, the deficit on current account has continued to grow, even as the bulk of the dollar's appreciation has been reversed.

The failure of the conventional analyses is rooted in basic confusion about the source of the current account "shortfall." Rather than an indication of economic weakness, the current account deficit reflects that the US continues to draw more foreign portfolio capital than US capital is migrating to foreign destinations. The deficit on current account, in other words, is explained by the surplus on capital account. Because the US has investment opportunities exceeding its domestic wealth, it attracts wealth from abroad in the form of net capital inflows, which enable Americans to buy more foreign-produced goods and services than Americans sell into the global market.

The confusion over these cause-and-effect relationships is giving rise to a number of misconceptions, with potentially dangerous consequences. At nearly every turn, one reads that a cheaper dollar is required to continue attracting foreign capital in order to "finance" the current account deficit. The deficit, however, is self-financing. If the US weren't attracting investment funds from abroad and running a capital account surplus, it wouldn't have a current account deficit. A lower level of net foreign inflows would simply result in a smaller current account surplus; no financing issues would arise.

Certainly, the capital-account fear mongers could yet get their wish. If policymakers are not attuned to the danger, speculation that the US seeks a significantly weaker dollar could become self-fulfilling, reducing dollar demand, producing a sharp spike in inflation, and spurring capital flight. Assuredly, the current account deficit would then quickly fade as an issue of topical concern. Although we don't rate that as a high-probability risk at this point, the nearby chart of the G6 trade-weighted dollar index gives us some pause. Having completely reversed its deflationary appreciation of 1997 to 2001, the dollar is not far removed from falling into inflationary territory. Undoubtedly, that is a primary factor in the market's current case of inflation jitters. TM