

FED SHADOW

Passing the Buck

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There's one man in the world who can save the falling dollar -- and he won't do it.

After **Alan Greenspan's** [remarkable speech](#) in **Frankfurt** Friday, the path of least resistance for the dollar will continue to be lower with a **Fed** chief who appears perfectly willing to tolerate -- and even encourage -- a sustained currency depreciation.

In the wake of a spate of recent comments by other Fed officials appearing to talk down the dollar by linking it to the trade imbalance, Greenspan's silence on the issue prior to his Frankfurt speech at least offered the hope that he held a different perspective, which he would authoritatively explicate in due course. His remarks Friday, however, should be seen not only as validation of the weak-dollar trend, but an evasion of Fed responsibility for securing the currency's prospective purchasing power.

For all Greenspan's supposed erudition laying out the specter of "concentration risk" in continuing to finance the current account deficit with dollar-denominated assets, the markets bore witness to an impressive exercise in passing the buck, and responded accordingly. The Fed chairman's academic thumb-sucking about the questionable sustainability of foreign investment flows certainly wowed the media and Wall Street economic establishments. But for portfolio investors with capital at stake, Greenspan's speech was most significant for what it didn't say: that whatever the perceived risks, the Fed would stand as a bulwark against dollar devaluation, a task for which it is uniquely, and completely, empowered. That no doubt purposeful omission only intensified speculation that a cheaper dollar is exactly what our monetary authorities are seeking, sending the dollar to new lifetime lows against the euro and putting the price of gold in the shadows of the \$450 level for the first time since mid-1988.

Perhaps the most egregious buck-passing in Greenspan's commentary came in his pointing to the federal budget deficit as the linchpin of the current account, and by extension the dollar's fortunes. "Reducing the federal budget deficit (or preferably moving it to surplus) appears to be the most effective action that could be taken to augment domestic saving," he said, characterizing increased domestic saving as key to "policy success" in reducing the current account imbalance. In embracing the "twin deficits" concept, Greenspan has chosen to layer one canard on top of another in a fashion that is breathtaking to behold. For one thing, the debt incurred by the budget deficit -- about \$400 billion in the last fiscal year -- amounts to a small fraction of "dis-saving" relative to the robust recent growth of **US** household wealth. According to Fed data, household net worth in this year's second quarter grew to more than \$45.9 trillion, an increase of more than 10% from year-earlier levels. From a real-world economic perspective wealth and savings are one and the same -- representing the value of claims on expected future income streams, which are available to be collateralized to further support capital formation. Greenspan dismisses this reality *en passant*, referring to "valuation adjustments" -- yet it renders as fallacious the notion that the budget deficit represents a drain on domestic investment resources that must be offset by foreign capital, giving rise to current account

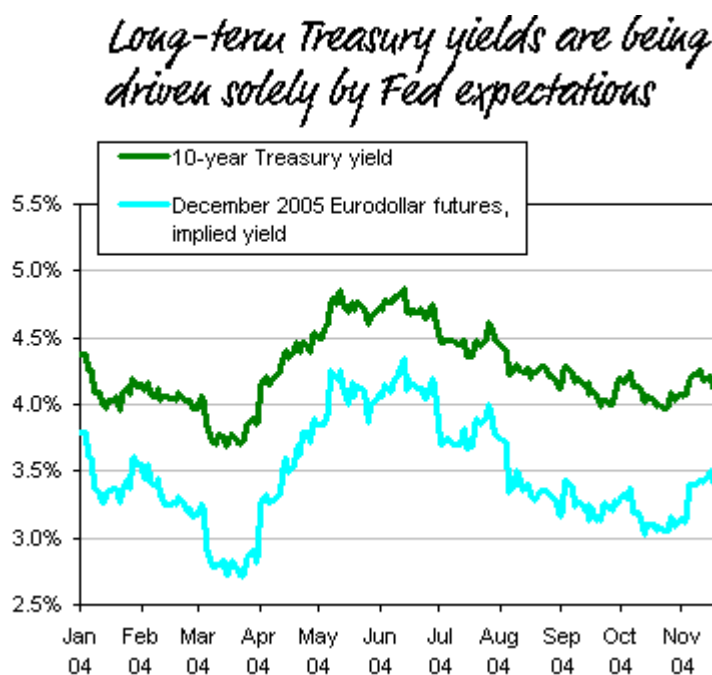
deficits. It's more the case that foreign capital is being drawn to the US by the wealth-creation opportunities documented by the Fed data, and the current account deficit is the tool financing the capital inflow.

Moreover, the "twin deficit" hypothesis is one that stubbornly refutes all attempts to empirically confirm its veracity, both domestically and in cross-country comparisons. Through the 1990s, the US current account steadily fell deeper into deficit even as budget shortfalls narrowed and eventually turned to surplus. If red-ink budgets caused current account deficits, meanwhile, how does one explain the consistent surpluses posted by **Japan** and **Germany**, both of which have higher budget deficits as a share of their economies than the US's 3.5%? Japan, with a budget deficit of more than 7% of GDP, runs a current account surplus of more than 3% of GDP. Germany has a budget deficit approaching 4% of GDP and a current account surplus of some 3.4%.

At one time in his long tenure, this presentation by Greenspan would have been totally out of character. During the first decade of his chairmanship, he consistently, and correctly, ascribed the dollar's value to entirely monetary factors, relying on indicators such as forex and gold as the most reliable feedback signals of the Fed's posture. In those days, he almost assuredly would have seen the dollar's decline as reflecting a stance that remains excessively accommodative, and would have developed an appropriate policy response. Now, for whatever reason, he is content to dodge the issue, pointing to diversions such as trade balances to avoid accountability.

Inevitably, there will be a price to pay. Greenspan himself may well believe the price-level implications of the currency's fall thus far remains within acceptable bounds, pointing to core inflation rates of no more than 3% or so. With the Fed on a schedule of "measured" rate hikes to restore policy neutrality, he could see the dollar's remaining downside as limited. Even if that ultimately proves correct, however, the bond market is one place where the downside risk is decidedly less limited. As we noted recently, based on historic experience the current yield of about 4.2% on the 10-year Treasury is priced for core inflation of less than 1% (see ["Stop Worrying and Love the Bond?"](#) November 18, 2004).

Our contention that long-term bonds are badly mispriced is not mitigated by suggestions that because the Treasury markets is such an enormous, liquid market, its pricing must efficiently reflect the collective judgment of the mass of investors with capital at risk. If there were a credible risk of sharply higher inflation, this thinking goes, Treasury yields would reflect it. Much as we might like to believe that, in this case the facts strongly suggest otherwise. The nearby chart tracks the 10-year Treasury against the implied yield of the three-month Eurodollar futures contract maturing in December 2005, a proxy for out-month expectations of the extent of Fed rate hikes. Regression analysis shows a correlation coefficient of 94.4% between the two this year. In other words, in this



episode long-term Treasury yields have been almost completely tied to short-rate expectations, which have been lulled into a sense of complacency reflecting the Fed's own relaxed mindset. We strongly suspect that time is running short for this "don't worry, be happy" bond market interlude. **IM**