TrendMacrolytics

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

POLITICAL PULSE

The Potential Price of Pandering

Friday, October 17, 2003

Donald Luskin

The administration's politicized dollar policy risks the market's confidence in economic recovery.

The **Bush administration's** public statements about dollar policy are getting increasingly psychedelic. The administration repeats the mantra that it supports a "strong dollar," yet at the same time calls for strengthening of the yuan and the yen -- which, in forex, terms, is the precise equivalent of a weaker dollar. It calls for exchange rates to be determined by market forces, yet that call itself is clearly an attempt to influence the markets. With **President Bush** embarked on an Asian tour now, who knows what he'll say next. Judging by today's action, markets are not exactly expecting him to cover himself in glory.

Our administration contacts are in lock-down on the subject. Other than **the president**, only **Treasury Secretary John Snow** is authorized to talk about it, and White House contacts portray it as very much Snow's own policy initiative. It's clear that no one wants to be blamed for a leak that could move markets -- and that Snow is the designated fall guy if this ends in tears. And we detect a sense of embarrassment about the whole matter among our more economically sophisticated contacts.

The only thing anyone seems willing to say is that the administration has to operate in a world of difficult political trade-offs. They argue that a high-level jawboning initiative to get **China** and **Japan** to strengthen their currencies probably won't succeed in the first place -- and if it forestalls bad legislation like **Senator Charles Schumer's** tariff initiative, it's a small price to pay. The comparison is made to the steel tariffs of 2001, imposed as part of a political trade-off that obtained fast-track trade negotiating authority for the president. But that's a false comparison. Whether or not it was wise, the 2001 trade-off was indeed a trade-off -- a bad-policy price was paid to obtain an arguably bigger good-policy payoff. In the present case, it's not a trade-off at all. There is no serious likelihood that Schumer could get his initiative enacted, especially if the administration were willing to make principled arguments about why tariffs are bad for the country and the world. If Schumer somehow prevailed, **Bush** could veto the bill.

But the administration doesn't want to make those arguments, or be put in the position of having to veto that kind of bill. And this isn't about trade-offs. Truth be told, the administration simply wants to score the very same political points that Schumer is trying to score -- by being seen as "doing something" to relieve the suffering of industrial workers who, at the moment, happen to be the losers in the never-ending cycle of creative destruction that lies at the heart of the capitalist system.

It's precisely what the administration did during the legislative frenzy following the **Worldcom** scandal. Fearing being run over by a political freight-train, Bush jumped in the cabin and pretended to drive. The result was the **Sarbanes Oxley Act** which -- as it continues to phase in over the next year -- will impose increasingly insupportable compliance costs on every public company in America. One CEO we spoke with recently speculated that after 2004, Sarbanes

Oxley will make it so that a public company with revenues of less than half a billion dollars won't be able to afford to stay in business.

The administration achieved a spectacular legislative victory with its tax cuts earlier this year, because the president had a great deal of political capital then and was willing to invest it in something he deeply believed in. But what about now, with that political capital depleted? Can the administration stay the course? The tax cuts are beginning to work in every respect, yet not a day passes without an increasingly strident scare-story about the federal budget deficit. And every single **Democratic** presidential candidate is campaigning on the repeal of Bush's tax cuts. Will this administration stay the course, and have the courage to deal with the deficit through economic growth and spending restraint? Why should we believe that the administration won't come up with it's own version of repeal, to try to take that issue away from the Democrats -- just like it did with Sarbanes Oxley, and just like it's now doing with the dollar? Don't you wonder what **National Economic Council chief Stephen Friedman** -- formerly of the **Concord Coalition** -- whispers to the president at the west wing water cooler?

If the economy continues to accelerate, that alone with take all these issues away from the Democrats, and none of this will matter. The problem is that today's dollar policy pandering constitutes a significant risk to that acceleration. Over the last several weeks the pace of consensus earnings upgrades has slowed markedly, even as the stock markets have crept tentatively to new recovery highs. We detect a sense in the market that we are now at a milestone, or checkpoint, in the recovery. Now is a moment when the administration has the opportunity to stick with the self-fulfilling bet on growth put in place by the tax cuts -- or to *really blow it*.

Such moments can last for months, and waiting for them to end is very destructive to the confidence that is so essential to growth. While we continue to be rewarded for our broad bets on recovery, these risks inhibit us from making a full 100% commitment in our **Model Position long the S&P 500**.