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Dangerous Game

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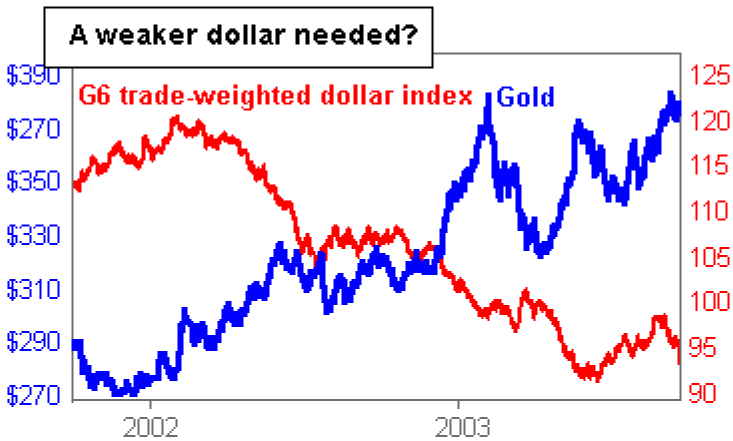
Treasury's ill-advised shift to an "activist" dollar policy carries potentially ominous domestic and international implications.

Treasury Secretary John Snow couldn't have been more pleased with his handiwork in **Dubai**, winning agreement from **G7** finance ministers on a communiqué calling for "more flexibility in exchange rates…based on market mechanisms." Clearly, this deceptively innocuous phrasing was a transparent veneer for the **Bush administration's** primary objective: encouraging a downward trajectory for the dollar on the cusp of an election year in hopes of deflecting criticism that it hasn't done enough to support domestic manufacturers and preserve jobs. The turbulent financial market response, however, suggests the effort could turn out to be one of the more politically short-sighted moves of this administration, with economic costs potentially swamping the evanescent benefits of a depreciated dollar. While at this point it is too soon to forecast the full implications of this forex policy venture, it stands both as a new source of instability in capital markets and a potential accelerant to the inflationary risks we have highlighted in earlier reports (see "Gold At $380" September 10, 2003).



It's axiomatic from our perspective that the value of a currency is ultimately determined by its central bank of issue, and that exchange rate movements between currencies reflect the differentials in liquidity posture among central banks. In the final analysis, a "weaker" dollar won't be sustained unless **the Fed** allows it to be sustained. But that doesn't mean great mischief can't be caused by misguided currency-cheapening forays such as this administration is now engaged in.

An important variable in demand for a currency is confidence in the sustainability of its purchasing power. With the Treasury now putting dollar policy in play, it's a virtual certainty that confidence in and demand for the dollar will fall. The Fed's archaic rate-targeting procedures, however, leave it ill-equipped to respond appropriately to the unpredictable shifts in dollar demand that will certainly result. The risk is that the Fed's current rate-targeting mechanism, blind to ground-level readings of the dollar's supply/demand balance, essentially renders it powerless to forestall a potential dollar surplus before it becomes an inflationary reality.

The initial market response to the Dubai statement was indicative of that risk, with gold spiking above $386 for the first time in seven years, the dollar falling across the board against its major-

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currency counterparts, and bonds dropping by more than a point before staging a late-day bounce-back. The risk is made all the more real in the current setting by the Fed's apparent incognizance of the fact that it is already flirting with inflationary liquidity excess (again, see "Gold At $380" September 10, 2003).

As if to underscore the point, **Fed Governor Ben Bernanke** -- who has emerged as spokesman for the consensus supporting the Fed's highly accommodative posture -- suggested again yesterday that a slack labor market and unused industrial capacity meant the Fed could indefinitely sustain its easy stance. Once again showing no hint of understanding that a decline in value of the unit of account will mean higher inflation whatever the status of real factors such as capacity use or employment, Bernanke told a Washington conference, "The Fed may not have to respond by tightening with the same speed as it has in past episodes precisely because inflation is low and is not as likely to respond so quickly...as it has in past episodes."

Of course, the threat of a dollar moving to the beat of the domestic US political drum has potentially ominous international economic implications as well. Consider the plight of **Japan**, which has been -- along with **China** -- the primary whipping boy of the administration's campaign against "undervalued" currencies. China previously made it clear to Snow that it will move toward currency "liberalization" on its own schedule, and has the added advantage of not being a G7 member. For Japan, though, the G7 parlay came at a particularly inopportune moment. Its objective to keep the yen from rising above Y115/$ was already being tested by a market becoming increasingly inured to the sterilized-intervention shell game. At the same time, the Dubai meeting coincided with a leadership transition at Japan's **Ministry of Finance**, which left it without an authoritative voice at the session.

Although a few MoF functionaries downplayed the significance of the agreement, insisting that currency policy hadn't changed, the market seized on the opportunity, correctly betting that new **finance minister Sadakazu Tanigaki** would not defy a freshly ratified G7 policy as his first act in office. The yen's stunning move below 112, from less than 114 Friday and 117 a week ago, was the result. Equally indicative of damage to tentative signs of yen reflation: the 10-year JGB soared more than a point and a half, driving yields down by some 17 basis points to a one-month low of 1.2% (see "Japan's Reflation Clouded By Doubt" August 26, 2003). Moreover, the yen's strength was more than a reflection of the dollar weakness seen in the rising dollar price of gold. Yen gold fell to just above Y43,000 from nearly Y44,000 last week, and Y44,500 less than two weeks ago.

The notion, meanwhile, that US producers would benefit from a stronger Japanese yen is largely illusory. Japan has been mired in a decade-long monetary deflation, from which the first hints of relief have only recently surfaced. Without sustained currency reflation, the Japanese economy will continue to be a basket case, with imports held down in a stagnant consumption environment. Japan's net export position also would not likely be affected much by a currency shift. That position is primarily the result of Japan's perennial deficit on its capital account. Because domestic Japanese investment opportunities are dwarfed by its accumulated wealth, Japan sustains a substantial capital outflow. Like any bookkeeping ledger, international accounts must balance. Thus Japan's capital account deficit is matched by a current account surplus, the broadest representation of a country's trade balance. Without a decisive end to its deflationary misery, the signs of life seen recently on the Japanese investment scene likely will prove to be short lived, and the trade surplus will endure. TM