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The Federal Debt: How It Hurts The Dollar

There is a great deal of responsible-sounding boning in Washington about the public debt crisis se days. Between Ross Perot and the newly-elected ngress, the debate finally centers on *how* to reduce the t rather than on *whether* to reduce it. New "budget nciliation packages" are floated weekly and the mere t that it is discussed lends support to the dollar and the ck and bond markets. This is the good news.

The bad news is that a common and politically npting way to allay a nation's debt is *debt netization*, a policy that eventually results in severe lation and currency depreciation. The longer we take pay our federal <u>debt</u> the more likely we are to indulge this solution and experience the dollar weakness it olves.

First, some definitions are important. A budget ficit" is the shortfall in a given fiscal year. For ample, we speak of the "fiscal 1995 budget deficit".

A budget "debt" is the cumulative sum of the ficits. The $200 billion 1995 federal deficit contributes our roughly $4.5 trillion debt, a debt largely cobbled gether with the last 20 years' federal deficits.

"Monetization of the debt" is a process that quires an understanding of how governments borrow ney. Simply put, they issue bonds, notes and bills, curities that mainly differ only in the length of their aturity. Normally, the public and other governments y the securities - they loan the borrowing government e money for the period covered by the security and in turn they get interest payments and the principal nount is returned at maturity. But when a government onetizes its debt, its treasury securities are purchased y its central bank. It pays for them with banknotes rinted by or with a check drawn on the central bank, hich funds then become a part of the primary reserves f the commercial banking system (because the seller posits its receipts from the central bank into its account t a commercial bank). The transaction is slick because of the neat capacity of central banks to write a check with no funds behind it - a central bank is *the* monetary authority in a country and can literally "write its own ticket". This process - a central bank creating money to pay for government bonds - is "monetization of the debt".

The problems with debt monetization result from the increase in the money supply when the central bank's check is deposited in the commercial banking system. Because the deposit qualifies as legally reservable funds, the increase in money supply is far greater than the deposit amount. In a fractional reserve banking system like ours, banks can loan more money than they have in deposits. The result of debt monetization, then, is *much* more currency chasing the same amount of goods and services - the classic definition of inflation. Furthermore, as every "Credit Markets" article in the Wall Street Journal warns, "bond investors hate inflation because it reduces the real return of fixed income investments" (the language and the article are in Section C everyday - see for yourself). So while the main problem described here is inflation, you can see that an attendant problem is flight from the country's bonds and therefore higher interest rates on new bonds and lower prices on existing bonds.

The second problem with debt monetization is that currency devaluation results from the inflation. Currency is subject to the law of supply and demand: a *greater supply* (from the check written by the central bank and the subsequent multiplier affect) coupled with static demand results in a lower price. The story is worse than that, however; typically, *demand for the currency weakens* resulting in a still lower equilibrium currency price. Specifically, foreign purchasers of the country's bonds shift their consumption towards securities that are less vulnerable to inflation. So instead of selling their yen, for example, buying dollars and using them to buy dollar-denominated bonds, they will buy Swiss or German bonds instead. The end result of this second

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continued

problem is that the final equilibrium price for the currency (whether dollars, yen, francs... any country's debt can be monetized) is even lower than described in the last paragraph. The increase in supply pushes down the price first, but the following inflation-sponsored decrease in demand lowers the price still further. It's a nasty problem.

This is the story of the monetization of the debt. It is one solution to a runaway public debt. The other solutions are higher federal taxes, lower federal spending, and/or a higher savings rate by the private sector so that more money is available to loan to the government. This country expressed an aversion to higher taxes when it elected the 104th Congress. Its savings rate will probably increase as the Baby-Boomers reach their forties, but the likelihood that federal spending will be reduced a lot is slim. The politicians that would reduce spending get booted from office if they don't throw money at their constituents. The recent flap from AARP is an example. The alternatives to monetization are either too little (the savings rate) or will be very late (higher taxes, lower spending).

The Federal Reserve is this country's central bank. Its formal, legal independence from the government theoretically allows it to make tough decisions without worry about political pressure from the politicians. Additionally, the Fed is currently legally proscribed from buying bonds directly from the Treasury; it can monetize by buying them in the open market. On the other hand, the President appoints the Chairman of the Board of Governors and Alan Greenspan's term expires soon....will Greenspan cow to political pressure to inflate - monetize the debt? Moreover, the Fed suffers increasing pressure from Congress, albeit to lower interest rates as opposed to monetizing the debt. Furthermore, Henry Gonzalez (Dem., TX) has recently lobbied to take the Fed's independence away. The point is that even in this country the central bank operates under political pressure. So what....?

In our second paragraph we noted how *politically tempting* monetization is. Because politicians don't have to raise taxes or cut entitlement spending and suffer their constituents' wrath if their solution is monetization, it presents an easy way out for them. History argues this will happen here. The Weimar Republic in post WWI Germany and a slew of South American hyper-inflations are examples of taking the easier way out. Each hyperinflation started with a rampant budget debt, and the politicians of each tried to wiggle out with monetization.

This is a currency newsletter-the U.S.' federal debt's affect on the dollar is plain. The bias for the dollar will continue to be bearish because the market anticipates that the harder answers - higher federal taxes, lower federal spending - will never see the light of day, and it anticipates that the supply of dollars will increase via monetization. Until a material policy change occurs, non-dollar currency will get more expensive for those of us with only dollars to spend.

One final point. Currently, the Washington jawboning is only about reducing the deficit by 2002. So even if that long-shot is realized, the outstanding debt will remain, with its attendant annual interest costs.....

What we expect ...

German mark. The Bundesbank (the German Central Bank, analogous to our Federal Reserve Bank) is suggesting an ease in interest rates. We look to hover around 1.35 near-term before an uptrade to the mid-1.50s.

British pound. Prime Minister John Major called his party's bluff - his offering of his resignation put mild pressure on the pound. His vote of confidence ended the blip. We look for a move up to 1.65 followed by a major technical dollar rally to 1.45.

Japanese yen. The impending bank and insurance industry problems may result in enough yen repatriation to below 80, but first look for a rebound to 95-100 as a genuine Japanese stimulus plan goes to work.

Canadian dollar. We expect 1.40 to hold, followed by an uptrade in the "little dollar" to the low 1.30s.

Mexican peso. The political concerns - with some notable, outspoken American exceptions - are easing. The result will continue to be increased foreign interest in Mexican stocks and bonds. That interest has to buy pesos to buy the securities - we look for the peso to rally to 5.75.

THE JAPANESE: STILL ON THE FRONT PAGE

Opinions differ on the strength of the U.S.' settlement of the car talks. American auto parts dealers love it - the settlement gives them greater access to the Japanese market. The financial markets' consensus, however, is that the settlement is toothless. Arguing that it has no place in agreements between private parties, the Japanese government refused to agree to police the settlement. The result is a settlement from which the Japanese auto industry can defect without fear of reprisal. At least the thing is off the front page of USA Today.....

Another Japanese crises threatens to impose on the dollar, however. Japan's banking system - commercial banks, trust banks, credit unions and long-term credit banks - is flirting with a bad-loan burden that could trigger a chain reaction felt in stock, bond and currency markets globally.

Some history is helpful. The Japanese Central Bank, the Bank of Japan (BOJ), proposed the $2 billion bailout of two lesser-known credit unions. The BOJ hoped to model a system-wide mop up after this bailout. A loan related scandal was uncovered at the credit unions, however, and the upshot is that other banks have shied from their agreement to help in the bailout. Tokyo's tax authority reneged on its commitment of $600 million, as well. The BOJ and Japan's FDIC (the JDIC) are hung with the bill.

Other, more cyclical history compounds the banking system's pain. A bona-fide deflation exists in Japan. Real estate prices have collapsed, so bank's loan portfolios are realizing big write-offs. The real loan trouble is concentrated in the Japanese S&L sector, *jusen*, and it just happens that the major S&L shareholders are the banks. Moreover, the deflation has affected corporate earnings economy-wide, so the banks' significant stock portfolios have suffered devaluations. In short, a constellation of factors casts a dark future for Japanese banks - their capital adequacy requirements are close to the point where loans must be called and stocks sold.

It is hard to know the exact point at which banks reshuffle - more likely, the decisions are made on the margin anyway. The suspicion exists, however, that a stock market sell-off below 14,250 Nikkei (the Japanese Nikkei is roughly their Dow Jones Industrial Average) dictates a large-scale stock sale by the banks in order to meet their capital requirements. Markets thrive on news. In the absence of news, they will whip up rumour. The 14,250 level could be rumour, but the suspicion is widespread nonetheless. Obviously, it is an admission against interest to confirm the story. The fact remains, however, that some stock price level exists at which they must take some losses and refund their capital, and the real estate loan, *jusen* and credit union problems exacerbate the issue.

What does this story mean for the dollar? In broad strokes, it means the Japanese banks will need to gather funds the best way they can. As holders of dollar-denominated assets, the Japanese are likely to sell them (whether they are U.S. securities, real estate or direct investment in U.S. companies) sell their dollars, buy yen and fund their domestic capital adequacy requirements. In broad strokes, it threatens downward pressure on the dollar as they sell them and buy yen.

The Japanese are doing what they can to maneuver around the problem. They recently lowered interest rates to an all time low in an effort to stimulate activity. More is expected. And the banking problem does not exist in a vacuum - as bond yields get lower and stocks decline over there, investors that can may sell those holdings, SELL yen and invest in other currencies that are stabler, offsetting the weakness of the dollar to the extent they buy dollars to spend on U.S. investments. Moreover, the Nikkei has rallied hard recently, closing above 16,500 for the first time since May 15 on July 12. Nonetheless, the bad-loan burden will weigh on the dollar and should be covered in the financial press over the next year. Watch 14,250.....

THINGS TO CONSIDER ...

- ★ Foreign investors bought a record $30 billion of U.S. Treasury securities in Q195 according to the Commerce Department. The prior record was $26 billion set in Q494.
- ★ The British have assumed the role of largest holder of foreign direct investment in the U.S., according to the Organization for Economic Cooperation and Development (OECD). The Brits bumped out the Japanese, who have moved money home for domestics reasons (see story this issue).
- ★ The German central bank, the Bundesbank, lowered minimum reserve requirements on Thursday, July 13. Its expressed motive was to "simplify" their banking system, but the fact is that it makes money easier to borrow in Germany. Perhaps lower interest rates follow - which is dollar bullish.

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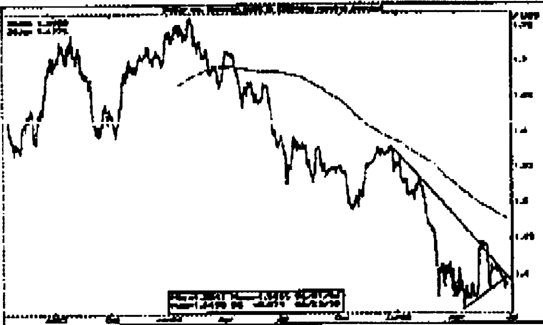

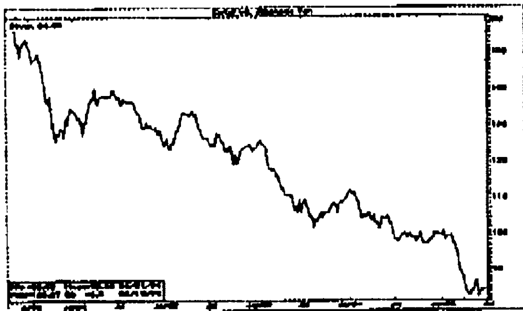

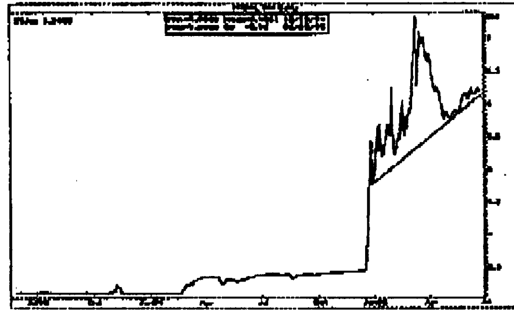

NEWSLETTER INSIGHT

Our objective for this newsletter is not only to provide you with relevant international information, but also insight into our current view of the market and how we plan to trade positions based on those views.

We make our recommendations to you (either through this newsletter or phone conversations) based on financial statistics, interest rate differentials, geo-political events, and technical analysis, that exist at that time. Also, we poll major money center banks and develop a consensus of opinions from "the players" in addition to the opinions developed by our interpretation of the market.

Because events occur so quickly, our newsletter can become "outdated" before you even receive it. As soon as your firm develops a foreign currency exposure give us a call. You'll be glad you did.

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