

### **Bush, Bonds & The Foreign Exchange Rate**

There exists a dichotomy between the foreign exchange market and the bond market. We have recently witnessed a sustained period of depressed bond prices accompanied by a very strong dollar. Domestic investors remain fearful of \$400 billion plus deficits, reasoning that much of the deficit will be monetized, eventually leading to higher inflation and hence higher interest rates which would mean capital losses. As a result, they are staying out of the long end of the credit markets. On the other hand, foreign investors continue to maintain long-dollar positions. In a sense, they have given a vote of confidence to the Bush Administration, even as domestic investors remain skeptical.

The usual explanation given to the above paradox is based on the proposition that bond rates are dependent on inflationary expectations while movements in the foreign exchange value of the dollar are primarily dependent on variations in real rates. If this explanation is accepted then there is no paradox.

However, this traditional explanation is suspect on a number of counts. One would expect that higher inflationary expectations would lead not only to lower bond prices but eventually to a lower value for the dollar as well. Furthermore, high real rates set into motion an array of economic adjustments which eventually lower credit demands while enhancing and rewarding an increase in savings. The longer real rates remain at abnormally high levels, the more probable it becomes that they will reverse course. The factors that affect the bond market cannot be separated from those that move the foreign exchange market.

Investors must make decisions on how to allocate their portfolios between competing assets including bonds and foreign currency holdings. They attempt to maximize the return on their portfolios subject to some asset exhaustion constraint over their planning horizon. As such, a divergence between the bond market and the foreign exchange market must eventually be resolved. The present status may continue for a transitory period, but eventually this abnormality will end.

One school of thought is that such major inconsistencies cannot persist for any period of time. The longer such abnormal economic behavior continues, the more probable it becomes that the conflicting economic signals must be reconciled. There are market forces that will eventually lead the economy back towards equilibrium. We do not doubt that self-correcting adjustment mechanisms do exist. However, we view the process of adjustment to market-clearing as taking a significant amount of time and involving significant costs. In fact, what many do not appreciate is that the economy could deteriorate quickly. High interest rates and a strong dollar are decreasing corporate earnings, which in turn leads to corporate liquidity problems. Sustained corporate

## VANDERBILT AVENUE ASSET MANAGEMENT

---

illiquidity leads to more business failures and increased government expenditure, leading to yet higher government funding requirements. Such a vicious cycle poses a bearish outlook for the savings and investment needed to reindustrialize America.

What is needed is a vote of confidence in the Bush program from the capital markets in order to help eliminate the above mentioned contradictions. Domestic investors are shying away from the bond market because they see the Treasury borrowing at rates that are not consistent with the Administration's long term inflation goals and because they are skeptical about its commitment. One possible action would be to set long interest rates at levels consistent with the administration's target rate of inflation. This may be easily accomplished by an auction process that declares the maximum yield that the government finds acceptable for long bonds. Such an action could cause expectations to adjust downward rapidly removing the high risk premium currently embodied in rates and spurring the recovery. However, such a program would have to be accompanied by positive actions on the part of the monetary and fiscal authorities. The setting of interest rates should not be viewed as a carte-blanche for irresponsible monetary policy as has been the case with past experiments. If inflationary expectations are to permanently adjust downward, the Fed must pursue a steady anti-inflationary monetary policy.

At the same time, the U.S. Government should begin borrowing overseas and avoid legitimizing high domestic rates. Furthermore, it is especially important for government to avoid a large presence in the credit markets as the economy starts to show positive growth. By looking abroad, the government would transfer part of the budget deficit into a bigger current account deficit, and help to move both the domestic credit markets and the exchange markets toward their equilibrium levels. These above recommended actions may well help to reduce the high level of skepticism about the administration's commitment to its announced economic goals and policy targets.

In conclusion, either the government behaves as if it believes its own interest rate expectations, i.e. by having the Treasury announce a maximum yield for its debt instruments and/or borrowing overseas, or it must face the same uncertainty as all other economic agents.