SPECIAL FX

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Monetary Policy in Focus, but Fiscal Policy may Prove More Formidable

The Federal Reserve Open Market Committee meets on November 4th for the second to last meeting of the year. With the central banks of Australia, UK and the euro zone also convening in the coming days, the focus is squarely on the trajectory of monetary policy.

The Reserve Bank of Australia is widely expected to hike its official cash rate, as it did last month, by 25 basis points. The Bank of England is expected to extend its quantitative easing program by purchasing £25 to £50 billion more gilts. No one expects any change from the ECB, but the Q&A following ECB President Trichet's statement may generate some insight into what officials are thinking, such as whether to adopt a variable rate repo rather than providing unlimited funding at a fixed 1% rate or simply eliminating 1-year funding next year.

For its part, the Federal Reserve is unlikely to change its assessment significantly. Short-term interest rates, reflected in the front-end Eurodollar futures contracts and Fed funds futures, have eased 6 to 7 basis points since the September 23rd FOMC meeting. The 12-month OIS/Libor spread has eased by nearly 20 basis points and is now discounting almost 90 basis points of tightening over the next year.

There is speculation in some quarters that the Fed's statement may modify its expectation that economic conditions will "likely warrant exceptionally low levels of the federal funds rate for an extended period." While it seems a bit early for that from the Fed's point of view, if this speculation proves correct, it could potentially trigger a sell-off in the debt markets, especially the short-end (resulting in bearish flattening), and a dollar rally.

Since Then

A review of the economic data that has been reported since the last FOMC meeting have generally been below expectations, with industrial production and retail sales being the chief exceptions. However now that the cash-for-clunker scheme is over, it is not clear how these two time series will fare.

The actual inflation picture did not seem to change very much either since the last meeting. Some hawks might point out that the 5-year/5-year forward, a measure of inflation expectations that has been cited by Fed (and ECB) officials, has risen from about 2.38% to 2.51%. Yet this measure moves around a bit and a closer look suggests it may simply be noise. The 100-day moving average comes in near 2.40% and the 25-day average is about 2.44%.

Many investors, or perhaps it is just the more vocal ones, might see inflation expectations in the price of gold, which has risen about 4% since the FOMC last met. It does not appear that Federal Reserve officials put much weight in the price of gold per se, though they rightfully seem interested in the drivers. The inflation signals indicated by the price of gold are not as obvious as its record nominal price, which would suggest the real price of gold, adjusted for inflation though not the carrying cost of storage and insurance, is well below its record. This year, gold is the worst performing of the precious metals.

Metal Prices	
Palladium	76%
Silver	46%
Platinum	43%
Gold	19%

Expressed as % of Record Price

Commodities in general have appreciated and gold may have been sucked up for the ride. The rising tide of liquidity, pumped in to head off an even more serious financial meltdown, is lifting nearly all boats, the dinghy alongside the yacht.

IMF = It is Mostly Fiscal

The expansion of the Fed's balance sheet, especially with less than pristine long-term assets and creation of an unprecedented level of excess reserves in the process, poses a monumental challenge. Federal Reserve officials have generally outlined the tools that can be deployed to facilitate the unwinding of the extraordinary monetary policy.

Of course, the official response to the crisis was not just monetary, it was fiscal too. As opaque as the Federal Reserve is often accused of being, it presently seems more transparent than the democratic government in Washington. If the Fed has developed a playbook on how to normalize monetary policy, what is Washington's playbook for normalizing fiscal policy? Arguably fiscal policy may prove more intractable a problem than monetary policy.

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If the budget deficit as a percentage of GDP is larger than the growth rate, the government debt-to-GDP, which is the more critical metric, rises. Yes there is a large cyclical component here, tax revenue from individuals and businesses have roughly been halved. Counter-cyclical expenditures, such as unemployment benefits, rise.

Consider that the budget deficit in the current fiscal year is projected to be near 10% of GDP, while the nonpartisan Congressional Budget Office projects around 3% growth. However, without significant remedial action, the CBO projects continued deterioration even in cyclical upswings.

Simply put, the basket of goods and services the Federal government provides costs 22-24% of GDP, though it has averaged almost 21% between 1969 and 2008. While there is far too much wasteful, pork-barrel spending, the source of the fiscal challenge is in the mandatory spending category, not discretionary. Even if discretionary spending was not marred by short-run political considerations, the fiscal challenges would remain daunting. The key lies with three major programs: Social Security, Medicare, and Medicaid.

Interest payments on debt are a mandatory obligation as well. Although the government's debt is rising dramatically, the low rates of interest (presently average maturity is roughly 48 months) keep the debt servicing costs to a minimum, but going forward it is difficult to envision interest rates staying this low for years, though it has been Japan's experience.

Revenues averaged almost 18% of GDP and the only time they have been above 20% was during the 1999 internet bubble. Some economists have estimated that to eliminate the budget deficit from purely the revenue side (not that anyone is really proposing this; it is more an exercise that illustrates the gravity of the situation), the minimum tax rate would have to rise from the current 10% to about 27% and the maximum tax rate would rise from 35% to 95%.

Fiscal Equivalent of Strong Dollar Policy

The U.S. is fighting two wars and has made the largest expansion of the basket of goods and services that the government provides (Medicare prescription drugs) without an increase in taxes. As was the case previously, the U.S. tried having both guns and butter.

There seems to be some limits to policy. It is hard to say that (or whether) the U.S. has hit those limits. One piece of evidence that it hasn't is that foreign investors have bought roughly 43% of the $1.41 trillion of U.S. Treasury notes and bonds sold in the first nine months of the year compared with 27% of the $527 billion sold in the same year ago period. But limits there are, even if one cannot identify them a priori.

The financial world would shake when U.S. Treasury Secretaries threatened to use the devaluation of the dollar to force their will on intransigent friends. The U.S. now forswears this with a pledge of favoring a strong dollar. When investors expressed concerned about the inflation implication of the Federal Reserve's purchases of long-term assets, the Treasury committed itself to issuing inflation-linked securities.

What investors, both domestic and foreign, are clamoring for is a fiscal equivalent of the strong dollar policy. Many investors doubt the U.S. has the political will to put its fiscal house in order. Most preferable would be a major re-thinking of U.S. budget priorities, but, short of that, forswearing new fiscal spending initiatives ahead of the 2010 congressional elections and verbally acknowledging that there are limits to fiscal policy may help bolster sentiment toward the U.S. dollar.

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