THE FED'S CHRISTMAS WISH

If I were Alan Greenspan and had one economic wish for Christmas, it would be unequivocally the return of a steeply and positively sloped yield curve.

The yield curve is an emotional and psychological early warning system which registers investors' consensus expectations for the future performance of the economy. The flat, or flattening yield curve, has traditionally been associated with disinflation, deflation and/or outright recession. Yet although every bona fide U.S. recession has been preceded by a flat, or even inverted yield curve, it is not the case that every flat, or inverted yield curve has correctly predicted a downturn. That ultimately depends in part on deft Fed and fiscal management, but more importantly, it hinges on the perceptions and expectations of wealthholders that the appropriate monetary and fiscal measures will stem the tide, stay the course, seize the day and ultimately steal the march. To better understand the positive dynamics of this process, it is instructive to observe an economy in which institutional gridlock is rife and timely action in abstentia....Japan.

Under the rubric that "things are so bad, they can only get worse," the Japanese economy has lapsed into an economic anomie that has become pathological. Dilatory in action, intempestive in resolve, Japan has consistently followed the inert and debilitating policies, both fiscal and monetary, of "too little, too late." Frozen in the ice of a factionalized polity, this pernicious stasis translates into frustration and discouragement in the outlooks of economic factors. As the economic environment deteriorates because of the fiscal and monetary authority's tendency to react behind the curve, fear of failure pervades the perceptions and expectations of economic factors. In that baneful state, both lenders and investors, consumers and businesses withdraw from the marketplace. Lenders become loathe to lend, fearing to book yet another non-performing asset. Investors' and businesses' animal spirits become enervated, mantled in the suffocating fear and futility of business failure. And consumers retrench spending, opting instead to save for the perpetual litany of rainy days from which they are convinced there is no relent. A vicious cycle of contraction ensues . Without hope for a brighter future, normal economic relationships deteriorate into a condition which macro-economists define as a "perverse" case. The effective supply and demand for money becomes totally inelastic, as does investment demand. Under those conditions, the Central Bank is truly "pushing on a string" in its efforts to expand credit, for neither the demand for money, nor nugatory investment demand will absorb fresh credit supplied by the Central Bank. In theory, because banks and investors are unwilling or unable to lend and borrow at any interest rate, in an effort to rid themselves of excess money balances, wealth holders will bid fixed income securities prices to infinity and interest rates will fall to zero. Egghead ramblings? Unfortunately, these scholarly machinations seem all too familiar, grounded in the antic reality of Japan's 1/4% overnight rate and 1.0% 10 year bond rate.

Japan has passed what may be termed as the "deflationary fail-safe" limit. It can be thought of as that point at which economic factors abandon all hope for recovery and economic malaise blights the landscape. It is that insidious syndrome that the United States must assiduously avoid. Decision makers must vigorously endeavor to change the endemic perception of impending disaster into that of opportunity, for in failing to do so, they emulate the Japanese model, wherein the perception becomes the reality.

Fortunately, at the helm of the U.S.'s economic respublica is Alan Greenspan, a man possessed of the power, prowess and the sang-froid to make the monetary miracles happen.

First and foremost, he must repudiate any possibility of paragoning the Japanese model and succumbing to the deflation fail-safe limit.

The dreaded spoor of deflation fail-safe is nascent, but nonetheless evident in the U.S. today. Feeling vulnerable and exposed, not only from foreign sector loan losses, but also from outsized, jeopardized credit facilities to Wall Street, bankers have tightened lending standards inordinately. It is not so much a question of the availability of the money to borrowers, but rather the reluctance of banks to "show them the money." It is this inelasticity of the collective banks' supply curve of money that becomes the problem, much as it was during the depression. And it is this deleterious dynamic which must be avoided.

How may the Fed thwart the dreaded deflation fail-safe? By delicately, but determinedly navigating the U.S. economy to the "threshold of inflationary expectations." By its own terms, this threshold implies an absence of deflationary psychology, and that absence is reflected in our old friend, a concertedly, positively sloped yield curve.

Recall that the contagion effects from S.E. Asia catalyzed opportunistic capital flows which inverted the Treasury yield curve. Specifically, the favorable interest rate differential between U.S. Treasury debt and Japanese sovereign debt instigated the "yen carry" trade, whereby yen is converted into dollars for investment into U.S. Treasury debt at a 3-5 point spread, depending on maturity. Allied with "flight to quality" trades by foreign capital and yield curve flattener arbitrages domestically based, the Treasury bond could only move in one direction...straight up with concomitant historically low yields.

Credit spreaders (also known as "risk," or "quality" spreaders) set positions relatively early in the Treasury debt rally on the presumption that the perceived, inordinately wide corporate and mortgage yield spreads to the curve would tighten. They didn't. Forced liquidations on loss positions aggregating into the billions of dollars ensued, spiking Treasuries ever higher and giving banker's newfound religion. Fear of failure closed the credit windows for all but the highest rated paper. The credit "crunch" and liquidity "squeeze" were on.

If it is the nocuous capital flows from abroad into our Treasury debt which galvanized hedger/spreader/arbitrageur positions serving to flatten the yield curve and give the banking sector dyspepsia, then simple logic would dictate that a prudent strategy for the Fed to follow would be to undertake any and all measures which would serve to steepen the yield curve. The most obvious remedy, of course, is to lower the Fed funds rate, preferably when the market least expects it. Such tactical implementation would provide the finesse to weaken the dollar slightly, unwind the yen carriers, catalyze the credit spreaders and rowel the yield curve steepeners, all to the good cause of steepening the yield curve, perhaps to between 100-150 bps front to back, a span sufficient to inculcate within economic factors the threshold of inflationary expectations. The fixed income market must be made to feel ever vigilant and "depayse," off-guard if you will, for the next possible Fed ease and not be allowed to presume Fed inaction, for as we have seen recently, complacency and certitude bred of the consensus that "the Fed is done" will only serve to rekindle the forces of capital flows tending to flatten the yield curve, thus working in contravention of the Fed's objective.

So a positive yield curve is the medium. Once achieved, salutary results would be forthcoming on both domestic and international fronts. The domestic dynamics are fairly straightforward and obvious; however, the international ramifications, particularly with respect to our burgeoning

merchandise trade deficit, is nuanced and intriguing and offers a result, specifically for the U.S., which gives the lie to those who hysterically adumbrate world deflationary Armageddon.

On the demand side, the U.S. is fortunate to be perpetuating a robust and grushie profile. Demand is alive and well on all levels: consumption is still tenacious and thewy, and the investment demand for money into the service economy is strong.

Facing an unambiguously, positively sloped yield curve, domestic lending institutions would be encouraged by the Fed's resolve to stimulus, and engage exuberantly in what they do best, deposit creation and credit expansion. Investors would shift out and along the downward slope of their elastic, investment demand curves, absorbing the newly created credit.

On the international front, it is no great revelation that the U.S.'s merchandise trade deficit has been deteriorating ever since the devaluation of the Thai baht in August 1997, the date generally considered to mark the prodrome of the S.E. Asian contagion. The loss of exports can never be considered a good thing, and certainly that diminution can and has subtracted from our GDP, as net exports have contracted. However, the natural laws of international trade bean counting militate that a merchandise trade account deficit is exactly offset by a capital account surplus. That is an accounting identity. Such capital account surplus constitutes a ready pool of savings available for deployment domestically into all manner of investments such as Treasury debt, corporate bonds, plant and equipment, etc. In a sense, then, that increment of GDP which is lost by operation of an increasing merchandise trade deficit, is offset by an identical added increment of domestic investment, a net wash to GDP. The layoffs at Boeing, Gilette and J&J today are supplanted by expansions at Microsoft, Yahoo, AOL and e-Bay. In fact, because our GDP comprises only 20% manufacturing and a whopping 80% service product, the substitution of domestic investment goods for the loss of primarily internationally traded manufactured goods proceeds at four times the efficiency, four times the facility than if the same substitution were limited to reinvestment into domestically manufactured goods, goods that would be more likely to compete with highly competitive foreign manufacturing. The fact the U.S. produces such a large percentage of GDP in service sector areas, within which it categorically holds the world's competitive advantage, will now serve to insulate it from the dire, deflationary prophecies of the Jeremiads.

Recall that in early 1997, many knowledgeable voices were pewling that the bugbear of inflation was poised to grip the U.S. in its maw of wage escalation. What followed, in lieu, was nothing less than the most spectacular drop in interest rate witnessed in over a decade, taking the long bond to record low yields, and this after the Fed firmed interest rates by 25 bps in 03/97. That which these seers suffered was prognostication based on the bane of static analyses; to wit, ceteris paribus, or all else being equal. But all else was not equal, as a strengthening dollar and excessive investment and over-production in S.E. Asia worked their wondrous anti-inflationary ways. These same savants, now reincarnated as latter day Chicken Littles, once again have fallen prey to the sinkhole of statism, wherein the U.S. economy will now succumb to a morbific contraction brought peremptorily upon it by imported world deflation. Once again, the fatal flaw in this faulty logic is that things will stay the same. Will they? You can bet the ranch against it.

The trade sector represents only 13% of our total GDP. Were it to decline chronically to 20% below normal, historical levels, it would subtract, ceteris paribus, about 2.5% from potential GDP, resulting in what the Fed would embrace as idyllic GDP trend growth at 2-2.5% per annum.

But factor in the substitution of domestic investment goods for internationally traded manufactured goods and GDP growth seems more likely to achieve a 3-3.5% rate.

To be sure, if the U.S. has demonstrated anything in the last fifty years, it is that it has an irrepressible and indomitable ability to parry the forces of deflation and bounce back resiliantly. From the Kennedy investment initiatives in the '60's to the supply-side Reaganomics of the '80's, it has never proven a good bet to short America. Moreover, through the myriad of normal, cyclical recessions in the U.S. during the past fifty years, none has ever asserted at the outset as a result of a weakened external trade balance.

The Fed must imbue to the world a sense of resolve that as long as externalities warp and wry the normal and stable relationships between and among economic variables, it will persistently and ineluctable lower the Fed funds rate. A slightly weaker dollar, which redirects a tranche of capital back to the nations that desperately need it the most, would be sanative. The Fed's persistently declaimed bias to easing posture would catalyze the capital flow mechanism necessary to achieve that end and steepen the yield curve. A much improved U.S. and, by transitivity, world outlook, would re-establish traditional financial relationships and restore normalcy to the markets.

To reiterate, it is imperative that the Fed disarm the fusionable mass of intermediary withdrawal before it goes critical and deteriorates into the Japanese model of economic languor and stagnation. It must assume an unpredictable easing bias and endeavor to steepen the yield curve. When, then, will the Fed know it has reached the threshold of inflationary expectations? In this high stakes game of monetary poker, it will be at such time as the bond vigilantes sell the bond on an incremental Fed ease.

As Christmas approaches, Alan Greenspan will fervently hope that his true economic love will give to him not "a partridge in a pear tree," but "a yield curve that's sloped like a tree."

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JAMES L. GRAUER
OMNITRAGE ECONOMICS
Sacramento, CA 95827
(916) 369-2583
http://www.stomaster.com
stoman@ns.net