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The appearance of crisis

The G-7 central banks are seeking, not a free fall in the dollar, but the appearance of fragility so as to frighten U.S. legislators.

The financial markets' sigh of relief on George Bush's election victory lasted all of two hours. By the time Europe awoke on the morning of 9 November, the U.S. dollar and U.S. Treasury bond prices were already heading rapidly downwards and the first phase of the Group of Seven (G-7) central banks' plan for the U.S. economy was under way.

The Bank of Japan chose the 9 November date to release its study of the U.S. budget deficit. This concluded that there was little room for optimism that the budget deficit would be reduced.

Japan's central bank was at pains, during the U.S. election campaign, to avoid expressing its views in ways which could be damaging to international confidence in the United States currency. It was a key policy-objective of the Japanese government that Bush be elected, because of the harm which a Dukakis victory would have done to U.S.-Japanese relations.

As soon as the Bush position had been secured, the Bank of Japan joined its G-7 partners in exerting pressure on U.S. legislators to slash federal spending and raise taxes.

This central bankers' strategy, fashioned within the Bank for International Settlements (BIS), is aimed at bringing about the appearance of crisis conditions in the financial markets. This, the bankers hope, will force the incoming U.S. administration and Congress to take action to cut the budget deficit.

The central banks have three key objectives. They are determined to curb inflation, whatever the cost to the productive economy. They will not allow public sector deficits to increase the credit circulating in the economy. And, finally, they are set on avoiding the kind of volatility which had featured in financial markets up to the beginning of this year.

In conditions of genuine market volatility, the central banks are unable to use the financial markets, normally their most reliable channel of influence, to exert pressure on politicians. Hence, what the G-7 central banks are seeking at present is not a free fall in the U.S. dollar, but merely the appearance of fragility so as to frighten the U.S. legislators.

There is every sign that President-elect Bush is sympathetic to this central bank strategy. One of his chief economic advisers, Martin Feldstein, was also active on 9 November, declaring that the U.S. dollar needed to fall by 10-20% over the next three years. This statement served to grease the skids under the dollar.

Doubtless, the incoming administration is grateful for any external help which may be forthcoming in softening up the Congress to acquiesce in an attack on federal budget outlays.

The strategy could be undermined if political events were to enhance the dollar's "safe haven" status. If, for example, OPEC were to succeed in limiting crude oil output, pushing the crude price up toward $18 per barrel, international funds might well flock back into the U.S. currency. An OPEC agreement, convincing enough to bring about such a rise in the oil price, seems unlikely, however.

More of a threat to the BIS central bankers' strategy might be a Soviet foreign adventure.

Even this, however, might have some negative implications for the U.S. dollar, especially if, in the interval between election and inauguration, the U.S. political response were weak.

A fresh cross-current in the financial markets is flowing from the Canadian general election. This looks increasingly likely to result in the establishment of a Canadian government which will refuse to ratify the Free Trade Agreement (FTA) with the U.S.A.

The chief significance of this is that the FTA between Canada and the U.S.A. was meant to serve as the model for a similar, and more important, FTA between Japan and the U.S.A. It was also meant to be the cornerstone of a North American Common Market.

The incoming Mexican government of Mr. Salinas de Gortari had been relying on this as the basis for its economic strategy.

If the Canada-U.S. FTA collapses, the mood of the U.S. Congress is likely to turn decidedly more protectionist. This could well sour U.S.-Japanese relations next year and render the financing of the U.S. budget deficit by Japanese investors more problematic.

The result will be higher U.S. interest rates. Furthermore, a major question-mark will be raised over Mexico's financing arrangements. The U.S. Treasury and Federal Reserve have already committed $3.5 billion to underpinning the Mexican regime, through last month's so-called "bridging" loan.

Much more may well be needed to be committed to support this bridge that leads to nowhere.

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