

The Politics of the US Dollar – Part 2

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We learned that there is a compelling correlation between the US political landscape and the health of the US dollar that is at least 20 years old.

To summarize this relationship, the US dollar has weakened an average of 2.55%, 2.03%, 2.1%, and 3.94% per annum vis-à-vis the British pound, Swiss franc, Canadian dollar, and Australian dollar, respectively during the Republican Presidential Administrations. Likewise, during Democratic Presidential Administrations the greenback appreciated an average 1.4%, 2.1%, and 1.1% per annum vis-à-vis the Swiss franc, Canadian dollar, and Australian dollar, respectively.

Moreover, we learned that the US dollar has respectively depreciated an average annual rate of -1.95%, -4.19%, -4.53%, -1.50%, and -6.74%, vis-à-vis the Japanese yen, British pound, Swiss franc, Canadian dollar, and Australian dollar, when the same party has controlled the Presidency and both houses of Congress.

Likewise, when political power has been shared between parties in the executive and legislative branches, the US dollar has respectively appreciated an annual average of 2.29%, 0.06%, 1.94%, 2.74%, and 1.31%, vis-à-vis the aforementioned currencies. What are some of the probable reasons that the US dollar fared better during President Clinton's eight years in office and why does the US dollar seem healthier when neither party has a political stronghold over both the executive and legislative branches of the federal government?

The Rubin Effect

Robert Rubin succeeded Lloyd Bentsen as the US Treasury Secretary in January 1995 and was

immediately tested by the so-called Mexican tequila crisis. With political cover from Clinton and economic cover from Federal Reserve Chairman Greenspan, Rubin orchestrated the provision of some US\$20 bn in loan guarantees to the Mexican Government through the Exchange Stabilization Fund.

Around this time, the US dollar lost more than 10% of its value vis-à-vis the yen and more than 13% vis-à-vis the Swiss franc. Rubin responded by publicly avowing a "strong dollar policy" that continues to be espoused by the current US Treasury Secretary, Paulson. Of course, there isn't actually a policy, per se, but the US Government cannot afford to go on record as indicating it supports a weak US dollar, which would tantamount to political suicide as it would likely result in higher interest rates on account of imported inflation and a higher yield requirement from foreign investors. Imagine the US Government promoting a weak dollar policy during the early days of 1995 when the US dollar was worth less than ¥100!

The Asian Currency Crisis

The period between August and December 1998 saw the US dollar depreciate from ¥147.00 to ¥113.00, a seismic shift that was preceded by the Asian currency crisis. Around that time, Thailand, Indonesia, and South Korea maintained large capital account deficits and maintained pegged currency regimes. When the Federal Reserve raised interest rates earlier that a decade, foreign capital passed on Asian countries and found its way to the US in search of higher yields and a flexible exchange rate. Economists will forever debate the causes of the



Asian currency crisis ranging from immature capital markets to global conspiracies to over-leveraged borrowing but the impact of the Asian currency crisis was felt long after it began in 1997. Arguably, Russia's financial crisis of 1998, the demise of US hedge fund Long-term Capital Management, and financial crises in Brazil and Argentina were by-products of the Asian currency crisis. Asian countries reacted to the Asian crises by devaluing their currencies to precipitate large current account surpluses and unprecedented holdings in US dollar foreign reserves and US dollar financial assets.

Trade Protectionism

Traditionally, the Republican party has been "pro-business" and a promoter of less government intervention in business affairs. There is little doubt that the tax cuts that were initiated a few years ago under the current President Bush have resulted in positive gains for the US economy.

Shortly after assuming the presidency, Bush instituted taxes on imported steel, partially in the name of political expediency and partially as a precursor to promoting a wide-sweeping free trade

agenda—and the US dollar did not respond in kind. It can be argued that while Bush's decision to pursue a trade protectionist policy may have benefited US steel manufacturers it was also a contributing factor to the US dollar's depreciation.

The Republican party's monopoly of political power in the executive and legislative branches of government during Bush's first term provided Bush with the political cover he needed to abandon some of the Republican party's traditional anti-protectionist policies and the result was a weakened US dollar. This is perhaps the most recent example of how shared political power may stymie a President's agenda but be beneficial for the greenback.

Conclusion

A myriad of factors have contributed to the US dollar's performance over the past 20 years including macroeconomic cycles, immature exchange rate regimes, and politics. It will be interesting to see how the US dollar appreciates during the final two years of Bush's presidency now that Democrats have a thin majority in Congress. ♦

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