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The Cosmic Risk: An Essay on Global Imbalances and Treasuries

Accelerating global imbalances are creating a colossal and little understood risk between governments and private international investors. This risk commingles the continuation and extent of official intervention in foreign exchange with US treasury markets. The clash between investors and governments is driving a menu of market anomalies, from exchange rates, to interest rates, to spreads. To come to grips with this confrontation and the implications for exchange rates, yield curves, and the global monetary system, we lay out our thoughts in a brief essay.

Our usual presumption would be that the private side would win this contest quickly and decisively. The old rule that no one ever went broke positioning against central banks is deeply ingrained in the memories of those who lived through the demise of the old Bretton Woods System. But that system did last for twenty years, and we see very strong incentives for governments to commit vast resources to the battle to maintain what we have called the revived Bretton Woods System. For the next year or so at least we are comfortable that the official sector can succeed in its defense of exchange rates.

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In this essay, we argue that the rapidly increasing domination of the official sector on the *buy* side of treasury markets is creating a technical factor that is separating benchmark yield curves from standard fundamental analysis. Current one-sided private sector positioning on future yield curve movements based on fundamentals are in fact gigantic risks taken against a phalanx of central banks and finance ministries engaged in a historically unprecedented intervention in foreign exchange and financial markets. These interventions well serve the purposes of the foreign official sector, and there is no reason for them to stop in the near term—we believe that the official sector will not cave. This means that it is underemployment in China and deflation in Japan that continue to drive the US Treasury yield curve in addition to the usual US business cycle conditions

Continued foreign exchange intervention by Asian central banks and governments will have two important effects on financial markets. First, by supplying a substantial fraction of US GDP to US credit markets, real interest rates in general will, we believe, remain below their historical norm perhaps by as much as one percentage point. Since real interest rates in the US have averaged about 2.8% in post war data this is a big effect. Put another way, regardless of what the Fed needs to do in managing inflationary pressures, a withdrawal of Asian support would require a narrowing of the US current account deficit and long rates would rise.

Continued intervention by official Asia would also tend to depress short treasury rates relative to other short rates because of intense appetite for these securities. Of course, the Fed can always sell enough treasuries to hit whatever Fed Funds target it wants. If inflation begins to return, the Fed would raise the fed funds rate, which would also raise the short treasury rates. Heavy Asian buying of short treasuries may push the bill rate down significantly relative to commercial paper but a wide enough spread would at some point lead to a switch to different securities.
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The Cosmic Risk

Poised at the rapid growth phase of the US business cycle, the US economy displays massive imbalances in its current and fiscal accounts. A strong recovery would, we believe, reduce the fiscal imbalance but would make the current account deficit much larger. Conventional fundamental analysis suggests that the deficits are inconsistent with low yields compared with euro rates and what still appears to many observers to be an overvalued dollar. Similarly, any undergraduate macro- textbook discussion on the business cycle and the Taylor rule for monetary policy would foresee an eventual rise in short term interest rates to about 5% (3% real growth plus 2% inflation), with similar though lesser rises in long rates. The yield curve might rise even more than usual because of the large supply of marketable paper falling on the market with a 5.5% of GDP on-budget fiscal deficit. Also, the USD would depreciate against undervalued Asia as well as the euro to bring the current account deficit to below a manageable 3% of GDP. The only question seems to be about timing, will this adjustment start mid-year or in the autumn?

Most private sector players have read the textbooks and currently are underweighting both the dollar and duration, counting on the business cycle to grind out the usual result. Others, perplexed by the persistence of low yields in the face of the fundamentals, have thrown in the towel and simply gone back to a neutral position.

But the private sector as a whole can become seriously one-sided in these positions only because of the eruption of the global official sectors as major buyers in the low-risk dollar asset sectors. A phalanx of central banks and finance ministries has emerged to resist, for their own local reasons, the adjustment that the cyclical fundamentals seem to require. These are mainly the Asian central banks and ministries of finance, but the Federal Reserve is also a major buyer with the fed funds rate set for now at 1%. Even the ECB, if it acts to stem the rise of the euro through direct intervention, may join this group. That this is not a concerted or organized intervention in US treasury markets does not diminish its power. It has created both a large fundamental and a huge technical factor that is bolted onto the normal cyclical adjustment with such weight that it can muffle its normal response.

Since the private sector as a whole seems to be taking a one-sided position, there is a vast risk position outstanding against mainly the Asian official sector. A few facts and a little arithmetic highlight the size of the risk:

a. Supply of US Treasuries[1]

Stock, End-December, 2003	
Marketable debt held by "public"	$3.50 trillion
Less Fed holdings	.66 trillion
Less securities held by Fed for foreign official	.85 trillion
Leaves less than	$2 trillion in private hands

New Supply, Fiscal 2004

The CBO estimates a $631 billion on-budget deficit and a $154 billion off-budget surplus. So new supply of debt in the hands of the public for fiscal 2004, is about $477 billion. If the ratio of non-marketable to marketable debt stays constant, the increment in marketable securities would be about $420 billion.

b. New Official Sector Demand for Treasuries

The Fed acquired about $64 billion of Treasuries in 2003 and $37 billion in 2003. Let’s assume it will acquire $40 billion in 2004, especially if there is no interest rate increase before summer. In Japan, the MoF is asking for authorization to sell ¥61 trillion (about $550 billion) for exchange market intervention in the next year.[2] If this is not a bluff and if the buying-in attack on the yen continues, that is a potential $575 billion of purchases of US treasuries at current exchange rates. Add intervention from China and the rest of Asia for perhaps $150 billion more.[3] Adding up, we find a potential official sector buy-in of some $750+ billion in the treasury market.

[1] The debt held by the public includes Federal Reserve holdings. It also includes non-marketable debt like savings bonds, special series for state and local governments, and other issues. The Federal Reserve reports Treasury ($0.85 trillion) and Agency ($0.21 trillion) securities directly held on behalf of foreign official claimants. The foreign official sector also holds Treasury securities indirectly through bank custodians, which are not captured here. The Asian official sector, which is the source of the growth, holds its treasuries through the Fed, while some European central banks do not.

[2] The limit for foreign exchange intervention was ¥79 trillion for fiscal 2003. At the end of December 2003, the amount outstanding was about ¥70 trillion. In the fiscal 2004 budget plan, the MoF intends to increase the limit to ¥140 trillion, including ¥20 trillion for a 2003 supplementary budget. The plan has to be approved by the Diet within the next few weeks. Note that the earmarking of the amounts seems to indicate an anticipation of yet another ¥20 trillion intervention in the last months of fiscal 2003, added on to the ¥21 trillion of calendar 2003, and a potentially matching ¥41 trillion in fiscal 2004.

[3] China increased reserves by $117 billion in 2003, but this number results after subtracting the $45 billion in reserves transferred in the recent bank recapitalization. These funds will apparently remain in USD assets. South Korea, Taiwan, and Singapore increased reserves by $34 billion, $44 billion, and $14 billion, respectively. This totals to about $255 billion. Even allowing for some tinkering with exchange rates, we expect Asian currency interventions on a similar magnitude to maintain the export driven development strategy. Setting aside some allocations for other currencies and securities such as agencies or corporates, we guess about $150 billion for treasuries for this exercise.

c. Supply vs. Demand

Suppose the buying-in attacks on Asian currencies and the euro continue from the private sector and the potential intervention actually occurs. Suppose also that the Fed continues its expansionary policy. Then the global official sector would absorb the entire new supply of treasuries and reduce the existing stock by $330 billion, i.e. by just about 17% of the stock.

The global official sector—with its preferences slanted to US treasuries at the short end—would then have engineered a significant shortage of treasuries, rather than the glut that fundamentals would cause us to expect. So we would expect forceful downward pressure on benchmark rates as this official-sector technical factor hits, enough partly to counterbalance rising credit demand due to the recovery.

A belief that the large buying-in attack on Asian currencies will continue this year and that official Asia will continue the defense is a belief that there will be a supply shortage in the US treasury market. Then the situation to compare to the present is not the run up in rates from 1993 to 1994 as the macro textbook would imply. Rather, it is the supply shortage of the 2000 buybacks, when technical factors persistently drove swap spreads vs. treasuries up by 50 basis points or more. In a low inflation environment with real yields around 2.5%, this would be a significant differential.

Private sector players are now inviting the Asian central banks to be the first to blink and unwind their positions by appreciating their currencies or diversifying their reserves, using the macro textbook as their rhetorical device. Yet, in deflationary Asian countries, notably Japan, it is difficult to understand why external players think there is some limit on the ability or motivation of the authorities to create yen in stemming a buying-in attack on the currency.

With interest rates at zero, it is costless to create as much yen cash as is demanded, while dollar reserves produce a positive yield. Normally, a limit on foreign exchange acquisition is reached when the resulting monetary expansion causes excessive overheating and inflation. But this is still not in sight for Japan, and would, in any case, be the monetary policy that economists have begged for to end their economic stagnation.

The lessons of attacks on fixed exchange, weak currency countries seem to be the ones being applied by the global private financial sector here. For such countries, there is a limit on reserves or credit or the amount of pain they are willing to put the economy through, so more attacks against such currencies are simultaneously a ratcheting up of the probability that the currency will indeed collapse. Speculators against the yen seem to be holding a case study of the peso against a mirror and thinking that the more yen they buy, the more they ratchet up the pain in Japan. Yet quite the opposite is true in deflationary Japan. The more yen the BoJ creates to counter this, the less the economic pain. If the MoF wins and the yen depreciates, it even gets a financial gain. We will look at this end-game scenario in a subsequent essay.

What limits yen creation in defense against a strengthening yen? Nothing. The other side of the coin of unlimited yen intervention in FX markets is unlimited buying of US treasuries. An ever greater MoF intervention is an ever greater support of US treasuries. That is why this is a cosmic risk. Who can stand the most pain from their unbalanced positions this year—the central banks or the private sector? Who is likely to blink first?

Conclusion

We are witnessing now a shift in global flows of historic proportions. The global unwillingness to accept the inevitable downward slide of the USD, due to a massive labor surplus in much of Asia and cyclical fears in Japan, is leading to intervention flows that are truly unprecedented. Now even the ECB has begun to publicly jawbone on appreciation of the euro. We are experiencing an official sector effort to reverse global private capital flows on a scale that we have never seen, even at the end of Bretton Woods. The emerging institutional arrangement, yet to be formalized, is a reconstitution of the Bretton Woods system that we have discussed in an earlier report.

But there is a serious position taken against the continuation of these interventions. If official Asia does blink, we expect two things to happen. First, the Fed would be more likely to see higher interest rates as necessary to control inflation in the face of a smaller supply of cheap Asian goods and cheap Asian savings. Second, long rates would rise more steeply because of the higher fed funds rate and because treasuries would not be scarce.

If Asia does not blink and inflation stays low, perhaps because of the supply of cheap foreign savings, we expect to see lower short and long interest rates, with short treasuries well below other short rates. Suppose that, in spite of continued Asian intervention, labor market tightness and incipient inflation triggers Fed action anyway. Then the rise in US rates would be less than normal business cycle history would suggest, mitigated by Asian intervention

Reference

"An Essay on the Revived Bretton Woods System", Michael Dooley, David Folkerts-Landau, and Peter Garber, Deutsche Bank Global Markets Research, September 2003.

Certifications

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