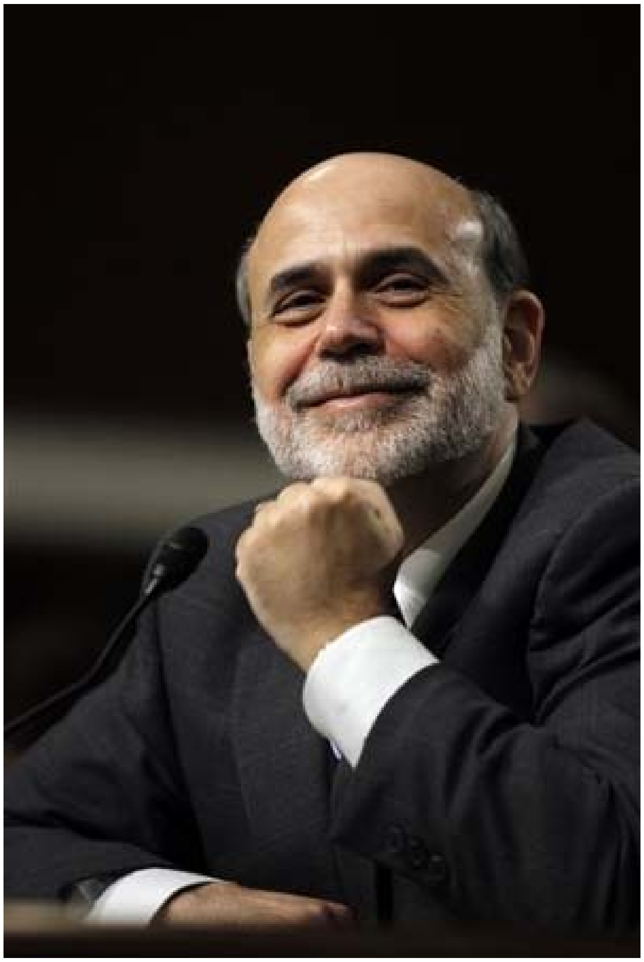
Why Fed Bond-Buying Plan Is Raising Trade Tensions

by THE ASSOCIATED PRESS



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FILE — In a July 21, 2010 file photo Federal Reserve Chairman Ben Bernanke testifies on Capitol Hill in Washington.

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The Federal Reserve's plan to buy more Treasury bonds has incited critics at home to complain of inevitable high inflation and financial turmoil.

It turns out many foreigners are pretty angry, too. They say the Fed's $600 billion program is a scheme to give U.S. exporters an unfair edge — one that endangers the global economy.

Is it? Or is the Fed's plan a credible way to help end a desperate jobs crisis and revitalize a still-tepid economy?

In either case, few dispute that Fed Chairman Ben Bernanke is taking a gamble. Whether or not his plan succeeds in aiding the U.S. economy, it risks triggering a trade war and encouraging dangerous speculation in financial markets.

Already, the finger-pointing threatens to wreck this week's summit of world leaders in Seoul, where the Fed's plan has set off vociferous debate. President Barack Obama on Thursday was forced to defend U.S. policies at the summit, saying "the most important thing that the United States can do for the world economy is to grow."

Many economists say the Fed didn't have much choice — not with U.S. unemployment stalled at 9.6 percent, short-term interest rates already near zero and Congress refusing to spend more to jolt the economy.

"They've run out of bullets," says Uri Dadush, director of the international economics program at the Carnegie Endowment for International Peace.

So the Fed announced plans to print enough money to buy an average of $75 billion in Treasury bonds each month for eight months. And it left the door open for more. The bond-purchase program is intended to energize the economy by forcing down long-term interest rates. Those lower rates might encourage some consumers and businesses to borrow and spend more.

Will the Fed's program do that?

Not likely, its critics say. For one thing, mortgage rates have already dipped to record lows without reviving the housing market, reducing high unemployment or stimulating much growth. Would people and businesses that can't or won't borrow now at super-low rates start borrowing if interest rates on loans dip a bit more — and borrow enough to rejuvenate the economy?

A bigger hope is that lower rates will lift stock prices. That's because, as Bernanke has suggested, investors will shift money out of low-yielding bonds and into stocks. Higher stock prices make people feel wealthier — and more willing to spend.

Business leaders are no different. They become more confident when their personal wealth rises and when their company's stock goes up. They're more likely to hire and expand. Once they do, the economy strengthens.

Yet the Fed's move threatens to inflame global tensions. That's because of what happens when it prints more dollars to lower interest rates: More dollars flooding the financial system will cause the dollar's value to fall. That will make U.S. products cheaper around the world. It will also make foreign goods costlier in the United States. Americans will be less likely to buy foreign products.

Economies like Germany and China, which have ridden a wave of exports out of the recession, complain that the Fed's main goal is to lower the dollar's value to give U.S. exporters an unfair price advantage. They call the move hypocritical because Washington has long complained that Beijing keeps its currency, the yuan, artificially low to boost Chinese exports.

In September, the U.S. trade deficit with China amounted to $27.8 billion. That's just short of August's record high. And it exceeds the U.S. trade gap with the rest of the world combined.

Critics also warn that rates kept too low for too long could inflate new bubbles in the prices of commodities, stocks and other assets. That's what happened before with technology stocks and home prices. Developing countries like Thailand and Indonesia fear that falling yields on Treasuries will send money flooding their way in search of higher returns. Such emerging markets could be left vulnerable to a crash if investors later decide to pull out and move their money elsewhere.

China this week unveiled plans to limit the inflow of so-called hot money. Other countries are considering similar controls on capital.

U.S. stocks have been surging and the dollar sliding since Bernanke said in a speech in Jackson Hole, Wyo., in late August that the Fed was ready to act further to help the U.S. economy. The Dow Jones industrial average has jumped nearly 14 percent. And the dollar has sunk more than 7 percent against the euro and more than 2 percent against the Japanese yen.

"For the rest of the world, the benefits are tenuous, but the risks are hitting them right in the face," Eswar Prasad, professor of trade policy at Cornell University, says of the Fed's bond-purchase program.

The acrimony over currencies and trade reflects global pressures that might be hitting a breaking point. For too long, many economists say, China, Germany and other big exporters have depended on U.S. consumers, instead of their own, to buy their goods and power their economies.

A weaker dollar "topples their entire strategy of relying on exports rather than internal reforms to fix the problems that ail them," says Diane Swonk, chief economist at Mesirow Financial.

Joseph Gagnon, a former Fed official and now senior fellow at the Peterson Institute for International Economics, calls the charge that the U.S. is manipulating the dollar "outrageous." He notes that China and other exporting nations have been buying dollars and each other's currencies to keep their own artificially low - a tactic the U.S. hasn't taken.

"We unilaterally disarmed," Gagnon says.

The U.S. trade deficit — the amount by which the value of imports exceeds the value of exports — narrowed 5 percent in September, to $44 billion. But through the first nine months of 2010, the trade gap is still running 40 percent higher than it was a year earlier.

And the broadest measure of trade — the current account trade deficit — will reach 3.2 percent of U.S. gross domestic product in 2010, up from 2.7 percent in 2009, TD Economics forecasts. The current account gap includes not only goods and services but also investment flows between countries. By contrast, TD expects current account surpluses of 4.7 percent of economic output in China and 6.1 percent in Germany.

China said this week that its trade surplus with the world rose in October to its second-highest level this year. That performance is likely to heighten pressure on Beijing to raise the value of the yuan as the Group of 20 summit of world leaders begins. A higher yuan would make U.S. goods cheaper for Chinese consumers to buy.

Carnegie's Dadush warns that individual countries must solve problems in their own economies, rather than point fingers at each other's. He says U.S. lawmakers should pass a short-term spending plan to jolt the economy, instead of leaning on a Fed program that could rattle world markets.

Then they should draft a long-term plan to shrink the federal budget deficit. The leaders of President Barack Obama's bipartisan deficit commission weighed in Wednesday: They proposed to pare annual cost-of-living increases for Social Security, gradually raise the retirement age to 69 and end some popular tax breaks like the mortgage interest deduction.

Dadush says China should let the yuan rise, to encourage its consumers to spend. China might then rely less on exports and more on its own consumption to fuel its growth.

Yet he fears countries will be tempted instead to further rig their currencies and impose barriers to imports.

"I've been watching trade for 35, 40 years," Dadush says. "I'm more worried about a protectionist resurgence than I've been in my professional lifetime."

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