By: Andrew B. Busch

Why Politics Matters For the US Dollar

As a reformed currency trader, I often can asked why I spend my time following what happens in politics. Does the resignation of Sen. Dodd really matter? Why should we care if Congress fights over health care or regulatory reform? What difference does it make if there's an estate tax or not? These are all questions that seem to have very little on the surface to do with currencies and the value of the dollar.

The best answer to all of this is that it all matters. Since the 1930s and the seismic shift of US governmental intervention into the private sector, the economy has been buffeted by the use of the very tools that were supposed to reduce variation in unemployment and growth. Namely, monetary and fiscal policy. As we are focused on politics, we'll look at the fiscal side of the equation which includes tax and spending policies.

Since the advent of the Federal Reserve in 1913, there have been three exceptional periods for the economy based on GDP growth, inflation, and unemployment. These are the famous seven fat years that occurred between 1922-29, 1962-68, and 1982-88. In **Econoclasts, Brian Domitrovic** writes, "The common policy thread running through each episode was the coordination of money supply with money demand and the institution of marginal tax rate cuts, including at the top rate. As Robert Lucas said in the Wall Street Journal in 2007, this represents no less than the greatest macroeconomic lesson of modern times."

With this knowledge, I return back to my original question of why I follow politics. On January 4th, WSJ's **Mark Whitehouse writes**, "Economists have long fretted about how an aging population and growing health-care costs will cause the U.S. budget deficit and public debt to balloon -- an outcome that could wreak financial havoc by undermining confidence in the U.S. dollar." (Also given what has recently transpired over Greece and their fiscal imprudence, can there be any doubt of politics immediate impact on the value of a country's currency?)

It is under these fiscally strained times of a $1.4 trillion budget deficit and an almost 20% increase in the level of overall government that analysts/economists/strategists fret about the outlook. The astounding 10% increases that Congress provided to the major government departments for 2010 is another reason for great concern. Turning to a large determinant for future spending, health care, the Cato Institute's Dan Mitchell **put out a piece** entitled, "Will the Federal Health Legislation Cause the Deficit to Soar?"

It reviews both the House and Senate plans and comes to these conclusions: "Deficits and debt will skyrocket if the government-run healthcare is expanded. This will happen if either the House or Senate plan becomes law. Big increases in federal spending and higher taxes are a bleak combination that would substantially slow U.S. economic growth."

It's this future that distresses me and typically raises doubts for foreign investors. Unlike Japan, the US is heavily dependent on borrowing from foreign investors. But don't just trust my judgment, read the comments from the United States largest lender: China. On March 13th, **Premier Wen Jiabao said,** " "We have lent a huge amount of money to the U.S. Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried." This was before health care reform legislation passed both Houses, I wonder what he would say today?

The US is in the process of violating the lessons of the "seven fat years" by not coordinating money supply and money demand via massive spending by the government. Every step the US government takes down this path, it takes the economy further away from the "fat years" towards the "lost decade" that occurred during the 1970s in the US and the 1990s in Japan.

This is why I follow politics and this is why it matters. This is why the medium to long term outlook for the US dollar is dismal unless something changes in D.C.

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