ECONOMIC VIEW

Deficits May Be Wearing Thin at the Fed

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WASHINGTON

T
ey are only low-level rumblings, oblique signals of discontent that are stripped of any direct political threat.

But as President Bush embarked on his second term last week, it was hard to escape the sense that his longtime honeymoon with the Federal Reserve may be ending.

The Fed and its chairman, Alan Greenspan, have arguably been Mr. Bush's most important economic supporters. Mr. Greenspan gave his blessing to the Bush tax cuts of 2001 and, less enthusiastically, to those of 2003.

Despite Mr. Greenspan's reputation as a staunch opponent of fiscal deficits, he tiptoed around criticism of the soaring federal debt that Mr. Bush ran up in his first term and will almost certainly continue to run up in his second.

Perhaps most important, the Greenspan Fed cut interest rates and showered the nation with cheap money to soften the recession of 2001 and to keep consumers spending through nearly three years of rising unemployment.

But something new is afoot, and it is not just that the Fed is raising rates back to more normal levels. So far, a measured pace of rate increases has merely reflected the Fed's increased confidence that economic growth is on a steady course.

The new element is a rising concern at the Fed about the nation's imbalances: the federal deficit, which hit $413 billion in 2004; a low and declining national savings rate; evidence of speculative behavior among investors and consumers; and the country's enormous trade and financial deficit with the rest of the world.

In November, Mr. Greenspan noted that foreign claims on United States assets - essentially the nation's net indebtedness to the rest of the world - were now equal to one-quarter of the nation's gross domestic product. The trade deficit this year is almost certain to exceed $600 billion - nearly 6 percent of the nation's economy, and still climbing.

"This situation suggests that international investors will eventually adjust their accumulation of dollar assets or, alternatively, seek higher dollar returns to offset concentration risk," Mr. Greenspan said. That, he continued, would make the cost of foreign debt "increasingly less tenable."
To most economists, such comments are simply a statement of time-honored truth: a borrower who runs up huge debts will become a bigger risk to lenders and gradually have to pay higher rates. But Mr. Greenspan's comments also carried a warning: rising budget and trade deficits come at the price of higher interest rates.

The Fed fired off another warning in the published minutes from its policy meeting on Dec. 14, saying, "a number of participants voiced concerns about domestic and global financial imbalances." Some members of the Federal Open Market Committee, which sets policy, were said to believe that the odds of "significant deficit reduction over the next few years were remote."

More surprising, the minutes said that some policy makers worried that the prolonged strategy of low rates might be fostering "excessive risk-taking" in financial markets and in the market for houses and condominiums. That sounded like a veiled reference to concern about a "housing bubble," an idea that Mr. Greenspan has repeatedly shot down.

A third veiled warning came on Jan. 13 from Timothy F. Geithner, president of the Federal Reserve Bank of New York. In a speech to financial executives about risk management, Mr. Geithner suggested that investors had become too complacent about risks posed by global imbalances - particularly those in the United States.

Declaring that the current account deficit had reached an "unprecedented scale," even as investors continue to demand very low risk premiums, Mr. Geithner warned that they had little buffer for unexpected shocks.

"The present fiscal trajectory entails an uncomfortable scale of borrowing and little insurance against possible adverse outcomes in an uncertain world," he said.

In private sessions, Mr. Greenspan may well be warning Mr. Bush in blunter terms. The Fed chairman meets regularly with Vice President Dick Cheney and periodically with Mr. Bush.

There is a rumor in Washington - thus far unconfirmed - that Mr. Greenspan warned the White House in mid-December that it would have to take more credible steps than it has so far to meet its goal of cutting the deficit in half by 2009.

If true, the unspoken but inescapable threat would be clear: if the Fed wasn't satisfied, Mr. Greenspan could signal his lack of confidence in Mr. Bush's fiscal plan. Investors would be shaken and Mr. Bush's credibility would be damaged.

What is certain is that the White House has started to signal tough cuts - trimming as much as $30 billion over six years at the Pentagon - and Mr. Bush has adjusted his rhetoric about the deficit.

Where administration officials routinely called the deficits "unwelcome but manageable," Mr. Bush and other top officials now describe deficit reduction as the cornerstone of their strategy for shoring up the foreign exchange value of the dollar.

Complicating the chemistry between the White House and the Fed this year is Mr. Greenspan's anticipated retirement in January 2006.

White House officials are trying to expand their list of potential successors. One early favorite - John B. Taylor, under secretary of the Treasury - is no longer in contention, according to people close to the White House.

White House officials are also cool about Martin Feldstein, the esteemed Harvard professor and director of the
National Bureau of Economic Research. Mr. Feldstein has been a passionate supporter of tax cuts and partly privatizing Social Security - Mr. Bush's top economic priorities. But some officials are still angry that Mr. Feldstein, chairman of the Council of Economic Advisers under President Ronald Reagan, criticized deficits run up by his boss.

MR. FELDSTEIN is not out of the running, but White House officials are looking at others. One would be R. Glenn Hubbard, an architect of Mr. Bush's tax cuts and now dean of the Columbia Business School.

A third possibility is Ben Bernanke, a Fed governor and a respected economist. While at the Fed, Mr. Bernanke, not a Bush insider, has impressed White House officials and is likely to be named chairman of Mr. Bush's Council of Economic Advisers. Though Mr. Bernanke would be a long shot to become Fed chairman, a successful tour at the White House could help his chances.

No matter who succeeds Mr. Greenspan, Mr. Bush will have to tread warily at the Fed. It is noteworthy that Republican Fed officials have tended to be more hawkish of late about raising rates sooner rather than later. The most dovish voice has been that of a Democrat - Janet Yellen, president of the Federal Reserve Bank of San Francisco. If tea leaves from the Fed indicate anything, it is that Mr. Bush could get tough treatment from officials tied to his own party.