

## BOND VIGILANTES AND FOREIGN POLICY

October Comment 2023

There is renewed talk of the return of bond vigilantes. The term, in a world increasingly prone to war, almost seems to signal the resurgence of sound regulatory control. It is about punishing those who recklessly take advantage of the creditors' as well as the taxpayers' money. The expression harks back to the experience of the Clinton administration which, between October 1993 and November 1994, saw Treasury yields on ten-year maturities rise from 5.2% to 8%, driven by concerns about huge government spending. Under the direction of the then Treasury Secretary, Robert Rubin, the President, supported by Congress, succeeded in bringing about a major spending restraint that saw the yield on the ten-year fall to 4% in November 1998. Clinton had swept aside rival George H. W. Bush. The then White House tenant had helped Ronald Reagan win the Cold War. He was confident that his historic success in foreign policy would guarantee him

another four years as president. But Clinton humiliated him by realising that Americans had other concerns: "It's the economy, stupid!".<sup>1</sup> The America of Reagan and Bush the father, had continued to weaken itself financially, in large part through significant military spending, to defeat the Soviet Union. But in the late 1980s and early 1990s, the US had gone through an economic recession, which had reduced tax revenues and increased government deficits. The bond market sniffed the danger by demanding higher rates, which would have further strangled growth. The Clinton administration then responded to the bond market's fears by implementing economic policies to reduce the budget deficit, increasing tax revenues and reducing spending. The beginning of that virtuous (at least in that historical phase) economic period was, however, preceded by the 'bond market massacre'.

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<sup>1</sup> The economy, stupid' was the phrase coined by James Carville in 1992, Bill Clinton's strategist in the 1992 presidential campaign. It was later

modified by him for a TV programme into "It's the economy, stupid!".

Today, however, the context is very different, although there is some similarity in the deliberate intention to punish the bond market again. There is a substantial difference with regard to bond vigilantes. These have been killed off in recent years, so much so that some large banks have closed down specialised trading in this area. Central banks first brought rates down to zero, and sometimes even into negative territory, to support the markets during the great financial crisis that erupted in 2007/8. Then, to oxygenate an economy that did not want to restart, they also acted on medium- and long-term rates by buying bonds on the market. These policies, which were supposed to be emergency, never came back and, in 2020, with COVID-19, they exploded by adding fiscal easing to monetary easing. All this could happen because the globalised world strangled prices and thus inflation. Without inflation and with a de facto nationalised bond market, the bond vigilantes had little to watch over.

The Clinton administration was acting at the end of the Cold War, which had been won thanks to the indebtedness capacity of the US dollar area. In that context, the political dimension of international

relations was relatively clear: Washington had demonstrated its unquestionable strength and could now reap the benefits of burgeoning globalisation in the economic sphere. The aim of politics was simply not to get in the way of the economy.

Joe Biden, on the other hand, is acting in the midst of a war in Ukraine, an open challenge with China over control of Taiwan, and with the powder keg in the Middle East increasingly difficult to contain. Moreover, the world has just emerged from a pandemic that has, with geopolitics, helped to curb globalisation. The role of politics has again become central along with the explosion of inflation. In addition, the BRICS, a term coined in 2001 by Goldman Sachs economist Jim O'Neill to refer to the major emerging economies (Brazil, Russia, India, China and then South Africa), are working to develop an alternative economy to that of the dollar area. This year, at its August meeting, the group decided to open up to new members (Iran, Saudi Arabia, United Arab Emirates, Argentina, Egypt and Ethiopia). The stated aim is to strengthen the emerging economies, which, by January next year,

will account for 36% of the world's GDP and 47% of the global population. It is also about countering Western economic hegemony by strengthening 'the confidence of many countries in the world,' says Narendra Modi, Prime Minister of India, 'in a multipolar world order'.

The current American administration is aware that the United States is no longer the absolute power that was able to defeat the Soviet Union. But, in a multipolar world, it intends to strengthen its hegemonic role to build a new world order based on its values. As National Security Advisor Jake Sullivan has clearly written, 'the essence of President Joe Biden's foreign policy is to lay a new foundation of American strength so that the country is in the best position to shape the new era in a way that protects its own values and promotes the common good'.<sup>2</sup> For the influential advisor, it is necessary to change the way the US thinks about power. "This administration," Sullivan writes, "came into office believing that international power depends on a strong domestic economy, and that the strength

of the economy is measured not only by its size and efficiency, but also by the degree to which it works for all Americans and is free of dangerous dependencies.<sup>3</sup> Biden therefore prioritised investment in innovation and industrial strength at home. This is the essence of Bidenomics. Public investment must also involve and stimulate private investment. "We are promoting new breakthroughs in artificial intelligence," Sullivan continued, "quantum computing, biology, clean energy, and semiconductors, while simultaneously protecting US benefits and security through new export controls and investment rules, in partnership with other allies. (...) We now estimate that public and private investment in these sectors will total \$3.5 trillion over the next decade. And construction spending in the manufacturing sector has doubled since the end of 2021'.<sup>4</sup>

From the economy, the presidential design shifts to defence. "When this administration took office," notes the president's man, "we discovered that although the US military is the strongest in

<sup>2</sup> Jake Sullivan, "The Sources of American Power, A foreign Policy for a Changed World", *Foreign Affairs*, Novembre/Dicembre 2023; (<https://www.foreignaffairs.com/united->

[states/sources-american-power-biden-jake-sullivan](https://www.foreignaffairs.com/united-states/sources-american-power-biden-jake-sullivan))

<sup>3</sup> *Ibidem*.

<sup>4</sup> *Ibidem*.

the world, its industrial base suffered from a number of vulnerabilities that needed to be addressed. After years of underinvestment, an ageing workforce, and supply chain disruptions, important defence sectors have become weak and less dynamic. The Biden administration is rebuilding these sectors, doing everything from investing in the submarine industrial base to producing critical munitions, so that the US can do what is necessary to sustain deterrence in competitive regions.<sup>5</sup> Of course, Sullivan admits, future administrations may have different visions of how to harness domestic sources of national strength. "But," he concludes, "in a more competitive world, there can be no doubt that Washington needs to break down the barrier between domestic and foreign policy and that increased public investment is an essential component of foreign policy."<sup>6</sup> And this must be done with the cooperation of the private sector, in coordination with allies and focusing on cutting-edge technologies.

Contrary to Donald Trump's strategy, Biden points to the consolidation of alliances because these, when well

aligned, express American hegemony. "Accordingly," Sullivan continues, "we have strengthened these alliances and partnerships in material ways that enhance the strategic position of the United States and its ability to address shared challenges."<sup>7</sup>

The war in Ukraine enabled the rebirth of NATO and Washington's undisputed centrality in the containment of Russian aims. But many other diplomatic and military plots have been woven by Washington's diplomacy: AUKUS (United States, Australia, England), Quad (United States, Australia, India and Japan) are just a few examples of impressive activism for a president now in his eighties.

However, the strategy has to be constantly adapted to changing geopolitics. The sudden exit from Afghanistan became necessary because 'it is very likely that Russia would be doing everything it could right now to help the Taliban to nail Washington there, preventing it from focusing its attention on helping Ukraine'.<sup>8</sup>

In September, with a view to interventionism that links politics and economics, the president announced a

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<sup>5</sup> *Ibidem.*

<sup>6</sup> *Ibidem.*

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<sup>8</sup> *Ibidem.*

new economic corridor (an American version of the Belt and Road Initiative) linking India to Europe via the United Arab Emirates, Saudi Arabia, Jordan and Israel, including joint infrastructure projects between Israel and its Arab neighbours.

In the original version of his article, written before 7 October, Sullivan admitted that 'this progress was fragile and that perennial challenges remained, including tensions between Israel and the Palestinians and the threat posed by Iran. The 7 October attacks cast a shadow over the entire regional picture, the repercussions of which are still unfolding, including the risk of significant regional escalation. But the disciplined approach we have pursued in the Middle East remains central to our position and planning in dealing with this crisis'.<sup>9</sup>

Within the framework of this discipline is total support for Israel 'as it protects its citizens and defends itself against brutal terrorists'.<sup>10</sup> And a clear and not very veiled warning to Iran: 'We are committed to ensuring that Iran never obtains a nuclear weapon. And while military force should never be an instrument of first

resort, we are ready and prepared to use it when necessary to protect US personnel and interests in this important region."<sup>11</sup>

The markets, until late August, had put their faith in Biden's political muscle. They had focused on the war in Ukraine convinced that the US was showing great strength not only in its military support for Ukraine, but also in its ability to consolidate and strengthen NATO. In addition, the Federal Reserve's steadfastness gave security with its open challenge to inflation, while fiscal policy continued to support growth. This was reflected in the widespread idea that high interest rates would mostly cause a soft landing of the economy that would soon push rates down. The mood changed after Fitch's decision to downgrade the US rating (from AAA to AA+), reserving the right to assess the Administration's future moves. Then came Jerome Powell's words that rates would remain high for a long time. However, the August correction seemed to be the precondition for the start of a rally in September, as US GDP surprised on the upside. But the fierce, dramatic and reckless attack by Hamas on

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<sup>9</sup> *Ibidem.*

<sup>10</sup> *Ibidem.*

<sup>11</sup> *Ibidem.*

the Israeli people and the violent reaction that followed, worried - and continues to worry - the markets, which did not see, in the albeit interesting corporate results, sufficient support to calm them down.

The bond vigilantes, who also witnessed the difficulties in nominating a new speaker in the House, lit a few danger bulbs. They started reasoning about Joe Biden's demands to Congress to fund the war in Ukraine (\$61.4 billion) and also Israel's war (\$14.3 billion) and pushed the ten-year Treasury rate to 5%: Treasury Department figures show the real deficit doubling from \$1 trillion in 2022 to \$2 trillion this year.<sup>12</sup> But in reality the markets, for now, seem only to have wanted to signal danger, without deciding on any significant changes of course. The ten-year has retraced to 4.8%, the S&P has lost just over 2%, and the dollar has been hovering around 1.05 against the eur since September. Oil, despite tensions in the Middle East, has not moved significantly either, hovering between 80 and 90 usd per barrel. The current reality is that the growth of the US economy, fuelled by Bidenomics, continues to

exceed expectations, while inflation is falling (CPI, 3.7% in September). The markets seem to give credence to America's determined foreign policy and to tolerate what is happening in the Middle East. And if the situation does not get out of hand, there might even be a chance for a stock market rebound. But we are approaching an election year. The BRICS countries, as well as the more hostile states like Iran, do not have, as yet, a coherent and propulsive force to counter Biden's design in an open manner. Where they can, they do not fail to support those entities capable of provoking local wars (perhaps this is the case with Hamas), multiplying the battlefields in which the United States is called to account.

The responsibility this Administration has taken on is such that it cannot afford defeats, on pain of losing credibility. If conflicts and tensions multiply, the US public debt and inflation will also increase. Bond vigilantes may be kept in check for a while, perhaps with 'twist' operations as in Ben Bernanke's time, to manage the yield curve. But then they will be back to demanding the fiscal discipline that runs

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<sup>12</sup> James Tweedie, "US Treasury Deficit Doubles as Biden Bankrolls Multiple Foreign Conflicts", *Sputnik International*, 23 ottobre 2023;

<https://sputnikglobe.com/20231023/us-treasury-deficit-doubles-as-biden-bankrolls-multiple-foreign-conflicts-1114427678.html>.

counter to Biden's goals: the price of gold at around \$2,000 an ounce, despite positive real rates net of inflation, already signals some concern. Of course, the challenger to the US presidency, whether old or new, cannot currently choose the motto that was Clinton's, 'It's the economy, stupid!'. But the risk of the American people growing weary of international tensions could perhaps lead him to choose the formula, "It's the foreign policy, stupid!."

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