

Prudential-Bache report links dollar drop to defense cutbacks

by Kathleen Klenetsky

The December 1987 issue of Prudential-Bache Securities' *Aerospace/Defense World Review* contains some observations not often found these days among the austerity-minded Wall Street set. Where most of their colleagues insist that slashing the defense budget, along with domestic spending cuts, represents the only road to fiscal health, Pru-Bache's analysts take a very different tack, arguing persuasively that defense spending is essential to American economic well-being.

Authored by Paul Nisbet, Byron Callan, and Miles Salliel, the study draws a direct link between the collapse of the U.S. dollar, and recent deep cutbacks in the Pentagon budget, and extends this linkage back more than 20 years. "We believe," they write, "that the international perception of the dollar is strongest when the United States is most concerned about its national security, as in the early Reagan years. We believe it is felt that wealth can be more safely preserved in the currency of a country that displays the will to be militarily strong." The report also warns that the INF Treaty could have a "negative impact" on Western Europe, leading potentially to the dissolution of NATO.

We quote from relevant sections of the report, which contains a graph which charts the dollar/defense-spending correlation.

"Former Defense Secretary Caspar Weinberger, who led the greatest peacetime military buildup in U.S. history, has left the Pentagon. . . . Weinberger believed that national security was the first priority of the federal government and not something to be compromised. We contend that if he believed otherwise and instead played the bureaucratic political games so dear to the hearts of Congress, the vital defense buildup . . . would never have taken place. In Frank Carlucci, Caspar Weinberger's replacement, we have the consummate bureaucrat. Perhaps this is what is needed for the times ahead; we have our doubts. . . .

"The dollar has taken a bad beating in recent weeks. We suggest a high correlation between the relative value of the dollar and the [downward] trend in defense spending. Intuitively, it seems there should be little, if any, relationship between the two. Indeed, some might argue that the dollar

should become weaker when larger sums of money are being spent nonproductively on defense.

"Exhibit 1, however, suggests the contrary. We believe that the international perception of the dollar is strongest when the U.S. is most concerned about its national security, as in the early Reagan years. We can be more safely preserved in the currency of a country that displays the will to be militarily strong. Now, when the U.S. is pursuing arms reduction agreements, the Congress is pursuing aggressive defense cuts, and the new Secretary of Defense is hinting at shrinking the size of the U.S. military forces, the international view is of a militarily weakening U.S. Consequently, it could be suggested, the dollar is being viewed as a riskier currency in which to put one's trust. Conversely, one could conclude that the outlook for a still weaker dollar is based, at least in part, on prospects for a still weaker U.S. national security. Many have related the market crash to the declining dollar. Could it be that Caspar Weinberger was serious when, on the October 20 Today show, he contended that the stock market crashed because of fears that his budget was not high enough?"

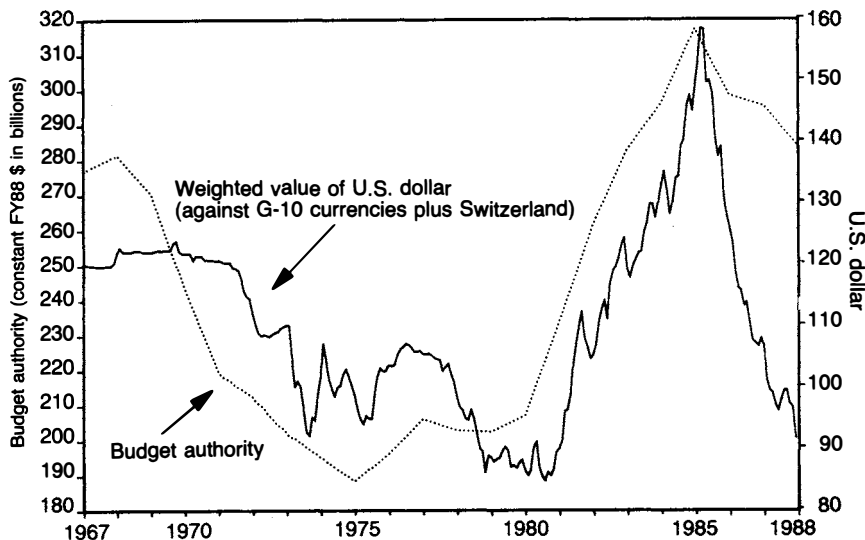
INF the beginning of the end of NATO?

After warning of the effects of defense-spending cuts upon the dollar's strength, the Pru-Bache study took a skeptical look at the INF Treaty, taking note of the strong objections raised by many European leaders, as well as prominent Americans, notably former NATO Supreme Allied Commander Gen. Bernard Rogers. Coupled with Congress's shift into isolationism, the agreement could mean the "beginning of the unraveling of NATO":

"We see an outside chance that the scrutiny given to the treaty by the U.S. Senate, absent a rapid change of heart by the administration, could cause support for the agreement to atrophy. But we doubt this will happen, given pressure that is now on in the West to follow the treaty provisions in any case.

"With expectations, however, that an agreement will be ratified, we fear that its impact on the NATO organization could be negative. We believe it will take strong leadership

U.S. DoD budget authority vs. weighted value of U.S. dollar



Source: Federal Reserve, Prudential-Bache Securities, Inc.

toward an improved joint-European defense to maintain the current cohesiveness of the NATO alliance. Without this, the outlook for spending by the European nations could deteriorate.

"It also appears that the U.S. Congress may be becoming more isolationist in its quest for means of reducing defense spending. . . .

"The proposed arms agreement has lowered some tensions in Europe and raised others. The trend, however, appears to be toward lesser tensions and lower defense spending—the first step toward uncoupling. . . .

"It appears that if the rate of European defense funding does turn for the worse, U.S. congressional defense leaders, led by such stalwarts as Sen. Sam Nunn, will only intensify their efforts to cut off U.S. NATO funding in response to what they have been viewing all along as inadequate support from the other NATO countries. *Given reduced nuclear forces, the only alternative to heavier defense spending by the European NATO nations will be to seek political and economic concessions from the Warsaw Pact countries*" (emphasis in original).

What's wrong with the treaty

In discussing the dangerous ramifications of the INF agreement for Western security, the Pru-Bache analysis also reports on some of the opposition to the treaty that has been voiced by Western European and U.S. strategists, including and the United States, focusing on the attacks leveled by U.S. General Bernard Rogers, who retired in June as Supreme Allied Commander in Europe. Noting that Rogers

"holds a position similar to . . . French and U.K. leaders," the study reports that he "believes that Europeans feel that the U.S.A. considers arms reduction as an end in itself. He points out that without intermediate- and short-range tactical nuclear missiles, NATO has only its 20-year-old F-111s under its command as a nuclear deterrent capable of hitting Soviet targets, just as in the 1970s, when the NATO alliance showed signs of unraveling. The Pershing IIs, against which there is no current defense, can reach Soviet targets with uncanny accuracy in 13 minutes—a strong NATO deterrent. The F-111s, to the extent they remain capable of penetrating Soviet defenses, would take hours. All other such nuclear weapons are controlled by individual nations, principally the U.S., whose interests could conceivably at times differ from NATO's.

"General Rogers believes that NATO joint control of nuclear deterrent weapons tends to bind the NATO nations together, and that with a significantly-reduced joint-responsibility deterrent force, Europeans will have increasing doubts about assurances of cover under the U.S. nuclear umbrella. He also feels that the INF agreement is but the first step in a Soviet move to denuclearize NATO and further weaken the bond between Europe and the U.S. . . .

"General Rogers feels that if the U.S. does lessen its support for Europe, a distinct possibility with Congress's current strong anti-defense stance, Europe will refuse to pick up the slack. Thanks to Congress, the U.S. is no longer leading by example in honoring a joint pledge from the Carter years that NATO countries maintain a 3% real growth rate in defense spending."