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FED SHADOW

Now What?

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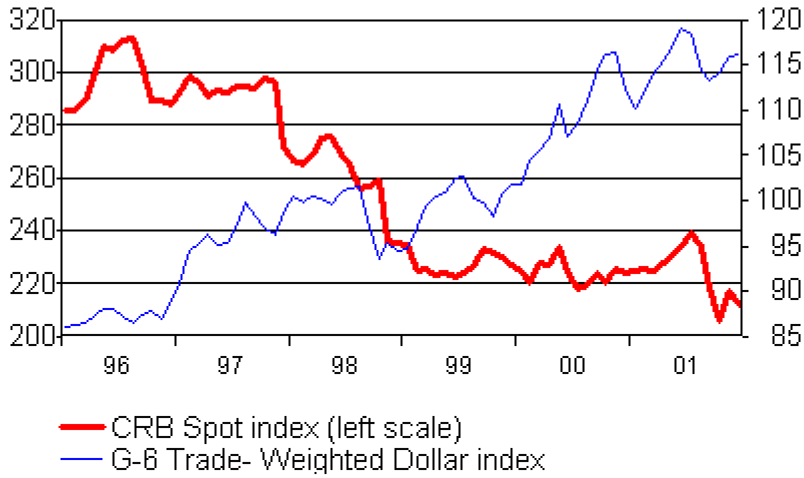
The coincidence of the dollar strengthening anew against foreign exchange and commodities as the **Fed** signals that its rate-cutting program is at an end should be, but probably isn't, giving policymakers some pause. With the dollar's forex value now restored to the 15-year highs of last summer and gold back below $280 per ounce, evidence that the Fed's 475 basis points in funds rate cuts since early last year has actually "eased" the availability of dollar liquidity remains scant to nonexistent.

Dollar Deflation



Unfortunately, though, there is probably no one among the current **FOMC** cast for whom the market price gauges of the Fed's policy stance rate more than a passing glance. From the perspective of the macroeconomic fine-tuning paradigm which dominates this central bank, the slashing of the overnight borrowing rate from 6.5% to a 40-year low of 1.75% is demonstration enough that policy is now "stimulative." The consensus view, in essence, is that healthy recovery is a matter of waiting out the customary lags between policy action and its economic effects. In fact, though, until the deflationary impulses evinced by the dollar's enduring strength are quelled, they are likely to pose prominent obstacles to a resumption of anything better than weak-kneed expansion.

The fourth quarter '01 GDP data scheduled for release this week will underscore the continued dollar scarcity. Quarterly growth of nominal GDP – also known as money GDP – is likely to register a few tenths of a percentage point on either side of zero. A negative quarter for nominal GDP would be the first since 1982. At the same time, the M2 money supply grew at a better than 10% annual rate in the quarter. That means monetary velocity – the turnover ratio of

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money in the economy – will have dropped for the sixth consecutive quarter, and should show a 4-quarter rate of decline surpassing the –6% seen in the third quarter.

In economic shorthand, declining velocity is synonymous with rising real demand for money, and an occasional quarter or two of falling velocity has historically been fairly commonplace, particularly following periods of heightened inflation when velocity typically surges. Over time, though, an uncorrected shortfall of money supply relative to demand takes on a self-sustaining dynamic. The pronounced velocity decline that we are currently experiencing is indicative of an excess demand for money raising the commodity value of the currency, driving demand higher still. Of course, the value of the unit of account rising relative to the goods for which it exchanges defines deflation.

We have held out hope at various points during this process that the Fed could get the overnight rate low enough to redress the deflationary imbalances of supply and demand in the market for dollar liquidity. Far preferable would have been a shift to a commodity price-rule orientation, avoiding the inefficiencies and distortions of the rate-targeting process, but we recognized that the institutional constraints against such a regime change were probably prohibitive. At this point, though, we don't entirely rule out the possibility that the conclusion of the rate-cutting cycle might have some positive impacts at the margin, compelling activity from economic actors who have been awaiting the bottoming of short-term rates. A stepped up pace of credit creation would heighten reserve demand, which the Fed would be forced to accommodate to keep the funds rate from trading above target. In that way, it's conceivable that what the Fed could not accomplish by lowering rates 475 basis points, it might realize by calling an end to the process. TM