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THOUGHT CONTAGIONS

Tempting the Monetary Fates?

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Calls for the Fed to ease now are as misguided as were the calls for tightening two months ago.

Yesterday's **FOMC** decision and post-meeting statement may have been the biggest nonevent since **the Fed** began same-day disclosure of the panel's actions more than eight years ago. Markets barely budged when at about 2:15 pm the Fed put out the universally anticipated announcement that the FOMC was keeping the funds rate target unchanged at 1.75% and maintaining a "neutral" balance-of-risk assessment. The only aspect of the release that could marginally be considered news was the acknowledgement that while the economy continues to grow, "both the upward impetus from the swing in inventory investment and growth in final demand appear to have moderated." The FOMC "expects the rate of increase of final demand to pick up over coming quarters," the statement said, "but the degree of the strengthening remains uncertain." To have suggested otherwise would have been to ignore reality.

Nevertheless, the Fed's stand-pat posture in the face of such uncertainty was deemed worthy of front-page treatment in today's *Wall Street Journal.* Under the headline "The Fed Leaves Rates Unchanged, Despite Anxieties Among Investors," the *Journal* presents as "news" a highly distorted vision of the function that monetary policy can and should be expected to perform. "A month ago, the economic recovery appeared to be moving according to script," the piece begins. "Now a crisis of confidence -- intensified by **WorldCom Inc.'s** accounting scandal -- is tanking stocks and the U.S. dollar, threatening to push the economy back into recession…**Federal Reserve Chairman Alan Greenspan** put on a brave face Wednesday, refusing to cut interest rates or even to signal that the central bank was considering such a move anytime soon."

The obvious implication is that the Fed should now be preparing to further ease policy in order to address a "crisis of confidence" -- and is being obstinate by “refusing” to do so. This reflects a remarkable 180-degree turn in conventional wisdom. Up until about the past week, the relevant questions were not *if* but *when* the Fed would begin *raising* rates, and by how much. The generally accepted answers were *soon*, and *by a lot*, although expectations in recent weeks had been receding swiftly on both the timing and magnitude of any rate-hiking action. Since late last year, our analysis has been that given an outlook for at-best moderate growth with virtually no inflation risk to speak of, expectations for an early and aggressive reversal of last year's rate cuts were unlikely to prove out. From our perspective, though, it would be an even more serious error for the Fed at this point to be seriously entertaining the notion that additional easing would be appropriate. In that regard, the *Journal* piece should not be seen in isolation, but as both a reflection of and contributor to the accepted wisdom that shapes public opinion and indirectly influences the policy process.

The fallacy at the root of the *Journal's* analysis, which is shared by conventional demand-based economic models, is that the Fed can be relied on as a growth regulator, easing when growth is deemed too weak, tightening when too strong. In reality, the most that any central bank can be asked to do is control the availability of monetary liquidity relative to demand so as to maintain

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stable currency purchasing power. In the late 1990s, the Fed erroneously deemed that growth was excessively strong. Its massively too-tight policy stance created a dollar scarcity resulting in deflation of the unit of account, as seen in the dollar's extraordinary multi-year appreciation on foreign exchange markets and the collapse of gold and other commodity prices. The bear market and plunging economic vitality of the past two years were the direct result. The recovery this year of the gold price from below $280 to around $320, along with the approximately 12% decline in the dollar's trade-weighted forex value, indicates that the monetary deflation has been substantially relieved, establishing the foundations for sustainable expansion.

This is not the time to tempt the monetary fates. Just as excessively tight policy in the face of an economic boom led to a deflationary wipeout, so an overly aggressive posture in relatively listless economic times would risk building a liquidity surplus and rekindling the fires of inflation. Indeed, that error is one with which the Fed has substantial historical familiarity, never more famously than in the great stagflation of the 1970s. TM

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