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Dollar Dynamics

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The dollar's appreciation against forex and gold might be just a technical phenomenon -- or it could mean that monetary deflation's not quite dead.

Given the extraordinary volatility in global financial markets over the past week, we are hesitant to draw firm conclusions yet from the dollar's abrupt strengthening against foreign exchange and -- especially -- gold. To some degree, the $20 gold price decline to three-month lows around $303 per ounce, and the somewhat more-subdued decline of the euro and other major currencies, has been a technical trading event precipitated by the reversal of earlier weak-dollar bets. The vacating of long-gold/short-dollar positions -- initially established in the belief that recent trends would be sustained -- created a dynamic that exaggerated the action. To the extent that the move reflects short-term trading exigencies rather than fundamentals in the supply/demand balance for dollar liquidity, some portion of it will likely be reversed.

Still, amid the palpable sense of relief on Wall Street that the equity markets seem to have found at least a tentative bottom, this strengthening in dollar purchasing power is a cautionary signal suggesting that relief from the scourge of **the Fed's** monetary deflation may yet be incomplete. Over the past few months of widespread "flight-from-the-dollar" hand-wringing, we have maintained that the action in gold and forex was largely a positive reflection of the Fed's less-stringent liquidity stance. We don't dismiss the dollar's decline as being a marginal factor in the equity market rout, as foreign-based investors acted to protect their US portfolios against the risk of further currency-related losses. But last week's trading also underscored the pitfalls inherent in a one-dimensional view of cause and effect in this multi-dimensional relationship. The dollar had its biggest forex move higher -- and gold its largest decline -- last Tuesday, the same day that the Dow hit new lows. It appears this response may have helped galvanize the sentiment shift which then led to further liquidation of long gold positions and covering of short dollar positions late in the week. The dollar's continued rebound, in turn, has likely provided some support to stock prices.

In the final analysis, though, equity prices are a bet on future profits, the growth of which will be considerably constrained in the absence of sustained Fed action to overcome its earlier run of disastrous deflationary error. Last month, in the face of much alarmist commentary regarding the implications of the dollar's moderate softening, we suggested that the move was a welcome one and "fundamentally based," pointing to a more generous Fed operating posture ("Going for the Gold" June 4, 2002). Now, though, the dollar's appreciation against key commodities and other currencies indicates that the Fed currently is failing to fully meet dollar demand.

While it's still too soon to know for sure, several potential explanations can be offered. It could be that dollar demand is rising as a consequence of grassroots expansionary forces which have yet to show through in the Fed's highly flawed and inefficient procedures for meeting the system's liquidity needs by pegging the overnight rate. If that's the case, it might be just a matter

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of time before rising reserve demand is accommodated by the open market desk. On the other side of the coin, though, it could also be that these operating procedures are particularly ill-suited to the current environment. In the face of still-depressed borrowing activity, the reserve demand which drives the Fed's liquidity supply has been ebbing for several weeks, with reserves declining at an annual rate of some 13% over the most recent four-week-moving-average period, after rising at a rate of 6% in early June.

At the same time, though, in this risk-averse climate, demand for essentially riskless interest-bearing cash balances -- which incur no reserve requirements -- has been rising strongly. In the same four-week period, Money Zero Maturity -- the Fed's broadest category of immediately available funds -- grew at an annualized rate of 12%, up from just 1.4% in May. It's possible that, if the current upturn in the equity markets is sustained, this risk-averse cash demand could soon be significantly reduced, helping to relieve the shortfall of dollar supply relative to demand. But until that demand is reduced -- or until the Fed accommodates it -- we will be concerned that renewed deflationary pressures will make an already risky economic recovery even more risky.

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