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A Deflation Dichotomy

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The Fed's finally fighting deflation -- but if deflation is already subsiding, then they're making a whole new world of risk.

Since **Alan Greenspan** surprised the markets on November 6 by lowering the fed funds rate by 50 basis points, the Wall Street economic fraternity and the financial media have been abuzz with one of the least-used words in the economics lexicon -- *deflation*. From **the Fed's** perspective, the more-aggressive-than-expected action amounted to a measure of insurance against what it belatedly perceives as the risk of a falling price level. That became clear when, a day after the **FOMC** meeting, the Fed released the summary minutes of its previous policy session. There the Fed as much as acknowledged that its rate-targeting mechanisms might need to be abandoned in order to provide the liquidity required to forestall deflationary conditions from taking root (see "Better Late Than Never" November 8, 2002).

For now, the Fed is hoping that, at 1.25%, the nominal overnight rate has been driven low enough to obviate that need. And the party line -- repeated by all central bank officials who have made public appearances since November 6 -- is that deflation remains a "remote" threat. It seems safe to say, though, that we are entering a period of significant policy uncertainty as the Fed gropes to find its way through a thicket of challenges which may require application of a more deft touch than it has historically been capable of.

To be sure, it does count as good news that Greenspan & Co. at least are indicating an awareness of continuing deflationary risks in the current environment, having denied their existence up until now. The market's most sensitive price indicators, of course, have shown deflationary influences at work in the US economy since early 1997 -- as we've been alerting clients all along. That's when the dollar began its forced march higher in a relentless revaluation that would ultimately see its real purchasing power appreciate by some 30% in foreign exchange and commodity terms by the end of last year. Significantly compounding its deflationary error, over the first three-plus years of this period the Fed was convinced that inflation was the pertinent risk, a misdiagnosis that caused it to ratchet up the funds rate to 6.5% by mid-2000.

The Fed's basic error was to confuse strong economic expansion with inflation risk under its archaic, Phillips Curve-inspired output-gap model that arbitrarily posits a level of "potential" growth. A rate of expansion faster than that "potential" rate is presumed to constitute "excess aggregate demand," which presumably leads to inflationary consequences for the currency. In reality, the Fed's posture all along was biased toward creating an increasing scarcity of dollar liquidity relative to demand. This meant that even as Greenspan was issuing regular warnings about the dangerous depletion of the "pool of available workers" and other inane rationalizations for fine-tuning the economy right into recession and the stock market right into a crash, the real value of the unit of account continued to rise. In the name of countering a non-existent inflation threat, in other words, the Fed was engineering an historic deflation of the dollar.

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With a focus on managing real economic variables -- employment and output growth, in particular -- the Fed was largely blinded to the impact of its actions on the currency's purchasing power, which in fact is the only variable any central bank has the power to reliably influence. In overlooking the effects of its overly tight policy stance, the Fed was aided considerably by the long lags built into the official price indexes. Due to the long maturity of debt and contract lengths built into the structure of the US economy, shifts in monetary value which show up first in spot currency and commodity markets take years to feed through the price system before being fully reflected in the statistical indexes. Even now, nearly six years since initiation of the deflationary error, the personal consumption price index is rising at an annual rate of about 1.75%, and the Fed's concern is officially couched in terms of a too-rapid "disinflation."

Such has not been the case, however, in dollar-linked emerging market economies, which offer a purer read on the impact of shifts in the dollar's value by virtue of much more rapid price-level adjustments. China and Hong Kong, for example, have endured several years of outright deflation, with China's CPI bottoming at a year-on-year rate of negative 1.3% in April. Since then, however, deflationary readings have eased markedly, and while the Chinese CPI is still showing a decline of 0.8% year-over-year, the index is now up 0.6% since April. That change in direction closely followed on the heels of market price indicators showing that the dollar has reflated considerably since early this year. Gold, in a range around $320, is up by some 15% and the dollar's value against the other major currencies is off by some 13% on a trade-weighted basis.

All of that could well suggest that the real threat of deflation is past, and by focusing monetary policy on it now, the Fed would be guilty -- as usual -- of "fighting the last war." That prospect is made relevant by the rampant confusion pinning the threat of deflation on the economy's hesitant recovery, when in fact it is deflation risk that has impeded the blossoming of a more robust expansion. If deflation has stopped, yet the Fed starts cranking up the monetary printing press to fight it, inflation will be the result. This would be the mirror image of the Fed's deflationary error, when it aggressively tightened the availability of liquidity in the mistaken belief that inflation lurked in an economic boom that in important respects was built on the collapse of both reported inflation and inflation expectations.

As suggested previously, we welcomed the apparent awakening of the Fed to the deflation risks which continued to present an obstacle to risk taking and growth. From our perspective, those risks were tied primarily to uncertainty over whether the Fed would allow for the reflationary impulses seen since earlier this year to be sustained. Now, we seem to have reached an inflection point where those uncertainties could well be superceded by a new risk factor. It's a double risk, really. Right now the Fed is considering having to abandon its interest rate-setting mechanism for some as yet unknown new approach -- and that's a risk. But even if it works perfectly, there's the risk that it will end up treating a disease that the patient doesn't even really have anymore -- and making the patient ill in the process. No wonder the markets have been so volatile over the past week. Compared to this double risk, the market consequences of an invasion of Iraq are trivial. TM