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FED SHADOW

Clear Opacity

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A muddled Fed contemplates applying monetary solutions to non-monetary problems.

If yesterday's post-meeting **FOMC** statement was intended to foster confusion and uncertainty about **the Fed's** outlook for the economy and the likely course of policy in the coming weeks and months, it could hardly have been more astutely crafted.

While recent data -- most reflecting conditions existing *prior* to cessation of hostilities in Iraq -- "have proven disappointing," the FOMC says, "the ebbing of geopolitical tensions has rolled back oil prices, bolstered consumer confidence, and strengthened debt and equity markets." Those developments "should foster an improving economic climate over time," and though the "timing and extent of that improvement remain uncertain, the Committee perceives that over the next few quarters the upside and downside risks to the attainment of sustainable growth are roughly equal."

Yet the FOMC finds that "in contrast" to that relatively favorable view, "the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level," and therefore "the balance of risks...is weighted toward weakness for the foreseeable future."

Got it?

Our hunch is that **Alan Greenspan** assented to this muddle in order to mollify various factions within the FOMC while maintaining a semblance of consensus. To some extent, this may be the manifestation of a sense of frustration at the Fed that, while economic performance is certainly not what anyone there would consider optimal, at this point there's not an awful lot for monetary policy to do to affect it in a positive way. We seriously doubt Greenspan actually believes that cutting a 1.25% funds rate to 1% or even 0.75% at this point would be an elixir to fix what still ails the economy. Nevertheless, endeavoring to maintain institutional relevance at a time of still-elevated economic uncertainty, Greenspan & Company felt compelled to engage in such a clumsy exercise.

Having so long remained in denial about the deflationary forces unleashed by its massively too-tight policy stance, we suppose the Fed now hinting at deflation risk, however belatedly and indirectly, represents progress of a sort. Our forward-looking model strongly suggests, though, that the Fed's deflationary siege is over, and whatever the remaining obstacles to more robust growth, they are *non-monetary* in nature. At this point, in fact, with real dollar purchasing power having reflated back to levels of five or six years ago (depending on the measure), the central bank at this point would risk inflationary overshoot with a significantly more generous policy stance. Yes, the lagging, backward-looking statistical price indexes now consuming the Fed show continued declines in measured inflation. Greenspan's favorite, the core personal consumption expenditure deflator, is up at an annualized rate of just less than 1% over the past

three months, down from about 2% just last fall. But the most sensitive market-based indicators including foreign exchange, commodities and gold all point to the earlier, long-lasting deflationary impulses having been reversed as a result of the accelerated pace of Fed liquidity injections beginning late last year.

Last month, we cited the Fed's liquidity posture in establishing a **Model Position long gold**, suggesting the price then of $325 per ounce appeared to reflect a selling panic precipitated by the dumping of safe-haven long positions coincident with the quick fall of **Iraq** to coalition forces. Based on monetary fundamentals, we noted, gold appeared to present a buying opportunity (see "A Bounce for Gold" April 9, 2003). With gold's price stabilizing in a range around $340 over the past week, it appears to have found at least a short-run equilibrium-based trading range, and we are closing the position this morning after booking profits of more than 5% on a cash basis, and 80% on a futures basis. TM