TrendMacrolytics

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FED SHADOW

How Much Will These Free Options Cost?

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Unworried about inflation, the Fed's trying to gun the economy.

The FOMC's decision today to lower the fed funds target rate by 25 basis points seems quite consciously to be an extension of the "free option" strategy that we have discussed before (see "Cats and Dogs Sleeping Together" June 10, 2003). The FOMC's statement today virtually spells it out --

> "With inflationary expectations subdued, the Committee judged that a slightly more expansive monetary policy would add further support for an economy which it expects to improve over time."

In other words, with inflation risk off the table, why not stimulate the economy as much as possible? Stimulus is a free option.

It's not that the economy has gotten worse. If anything, the FOMC's view of the economy seems to have become slightly more optimistic since the May 6 meeting. According to the May 6 statement, "taken together, the balance of risks to achieving its goals is weighted toward weakness over the foreseeable future." While today "the probability of an unwelcome substantial fall in inflation, though minor... is likely to predominate for the foreseeable future."

San Francisco Fed President Parry wanted even more of that free option -- he dissented at today's meeting, because he "preferred" a 50 bp rate cut. The Treasury market would seem to have wanted more, too, selling off hard immediately following the FOMC's statement today. But perhaps the Treasury market is seeing something else, as well -- that the dramatic drop in long-term rates, sustained by the Fed's exercise of its free option as long as it sees no signs of inflation, will be quickly reversed the moment the Fed starts finally starts seeing those signs.

That makes Treasuries a doubly dangerous game. First, evidence of deflation -- other than **the Fed's** jawboning and the media's Johnny-come-lately worries -- is completely absent from market prices. Gold, commodities, and foreign exchange have completely reversed their deflationary drops of the late 1990s, so for inflationary pressures *not* to creep back in, the Fed would have to engineer a perfect pin-point landing at just these levels. It's certainly possible, but with all the Fed's talk about deflation risk at this point when it's utterly irrelevant, one has to retain a certain amount of skepticism.

Second, suppose the Fed's free-option strategy pays off. Suppose inflationary pressures don't set in, and the Fed does manage to stimulate the economy to recovery (or just assume that the economy was on the road to recovery anyway). Long-term yields have to rise that way, too, as a recovering economy drives real opportunity costs, and real interest rates, higher.

Either way, bond holders are going to pay for the Fed's free option. And if new inflationary dynamics do get set into motion, everyone else will pay, too. TM

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