

FED SHADOW

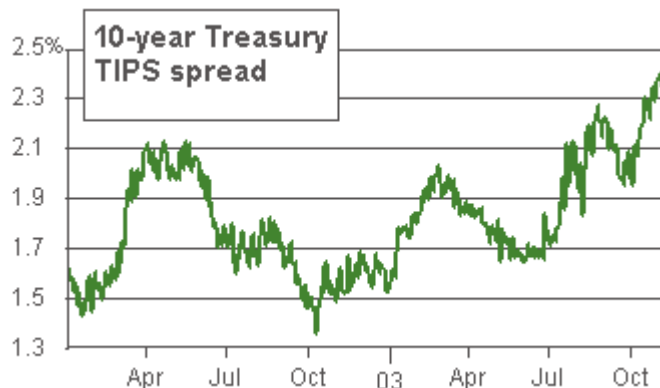
See No Evil

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If the Fed refuses to learn from inflationary history, are we doomed to repeat it?

As gold moves seemingly inexorably toward the \$400 plateau, the dollar resumes its retreat on foreign exchange markets, and portfolios opt for the shelter of inflation-indexed debt, the dangers of **the Fed's** "see no evil" approach to growing inflation risk are becoming all too clear.

This latest intensification of risk to dollar purchasing power comes as a parade of Fed officials have trotted out to "assure" the markets that any move to a less accommodative posture is not an immediate threat. But while they may have succeeded for now in sustaining the carry trade and capping long-term bond yields, the indecisive recent performance of equity markets can be seen as a sign of rising investor caution as nascent inflationary impulses begin to surface. One long-term danger for stocks: if the Fed gets much further behind the inflation curve, the inevitable catch-up will require significantly more aggressive and sustained tightening action than would now be needed to tamp down an incipient uptick.



Somewhat incredulously, we continue to observe a central bank that appears willing to sacrifice its inflation-fighting credentials in an ill-conceived effort to stamp out non-existent "disinflationary" pressures. In fact, these "open mouth operations" seem purposely intended to counter any impression that the Fed would soon be shifting its rhetorical stance in preparation for initiation of a rate-hiking cycle. That interpretation had been widely circulated following

release two weeks ago of the September **FOMC** minutes. The minutes showed the panel members anxious to jettison from the post-FOMC-meeting announcement the term "considerable period" as a characterization of its willingness to maintain a highly accommodative posture. "Given the uncertainties that characteristically surround the economic outlook and the need for an appropriate policy response to changing economic conditions, the

members generally agreed that the Committee should not usually commit itself to a particular policy stance over some pre-established, extended time frame," the FOMC said.

The thinking was that if the Fed was prepared to disclose its apprehension about the phrase in the meeting minutes, it would be unlikely to continue using it in subsequent meetings (the September minutes were released two days following the October 28 meeting). And, the thinking went, if the Fed was prepared to drop the reference to maintaining an accommodative stance for a "considerable period," the next step would be to prep the markets for the inevitable tightening. Over the subsequent three trading sessions, the spot price of gold fell from about \$386 to below \$377, reflecting the market's expectation that the Fed's open-ended commitment to today's low rates was likely drawing to an end.



Fact is, though, even if the Fed pursued this methodical, one-step-at-a-time approach leading to an eventual rate-hiking cycle, there is no guarantee that it would come soon enough to forestall a period of significantly higher inflation. As it is, the Fed's favored indicator of statistical inflation -- the core personal consumption expenditures deflator -- jumped from a 0.8% annualized rate in this year's first quarter to more than 1.8% in the third. Further acceleration is all but assured

given the decline of the dollar's real value over the past year.

But the Fed appears determined to remain unbound even by expectations of a gradual, phased process leading to higher rates and a reining in of its excess liquidity posture. **Fed chairman Alan Greenspan's** generally upbeat assessment of the economic outlook in a speech last week was interpreted by some as a "hint" that rates are likely to be raised in the not-too-distant future. We are dubious, however, that that was his intent, given that the text of his remarks cited the pabulum of recent FOMC statements that "the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation from its already low level."

Certainly, the remarks of other Fed officials commenting since Greenspan's speech give no hint of a change in view, or the slightest recognition of the risks now buffeting the unit of account. **Governor Ben Bernanke** remains chief spokesman for the consensus view that "the current low level of inflation... and the high degree of slack in resource utilization together leave considerable scope for a continuation of the currently accommodative monetary policy without undue risk to price stability," as he again put it last week. Yesterday, **Chicago Fed President Michael Moskow** chimed in with more on the same theme, offering that "it is appropriate to maintain an accommodative stance in order to provide some insurance against unwelcome disinflation."

As we have discussed in some detail in previous reports, this is a dangerously flawed conception of the factors driving the inflation process and what that implies for monetary policy. It reflects, at root, a failure to comprehend that inflation results from an excess supply of monetary liquidity relative to demand, thereby cheapening the currency's value relative to the goods and services for which it exchanges. All too often, when real factors enter the discussion under the "resource utilization" heading, serious monetary error is the consequence. The Fed's wrongheaded campaign to act against the conjectured inflationary consequences of a tightening labor market and "scarce" resources produced the disastrous deflationary liquidity dearth of the late 1990s. And the equally erroneous belief that "slack" resource use left ample leeway for the

Fed to pursue monetary expansion led to the "great inflation" of the 1970s and early '80s, the worst sustained decline in dollar purchasing power since the Civil War.

While the views of output-gap adherents such as Bernanke and Moskow perhaps are unsurprising, one is hard pressed to explain **St. Louis Fed President William Poole**, a reputed "inflation hawk," offering musings in the same vein. A monetarist in the **Friedmanite** tradition, Poole is ordinarily associated with a focus on behavior of the monetary aggregates as his primary concern. But in an interview yesterday, Poole cited real factors such as the economy's growth capacity in asserting that the Fed's current accommodative stance "could extend well beyond March."

In response to Poole's comments yesterday, the short-rate futures curve collapsed, with June Eurodollars -- which had been priced for an odds-on chance of 75 basis points in rate hikes -- now discounting for less than 50 bps. Meanwhile, the gold price -- although it backed off today from highs above \$399 -- is closing in on the \$400 levels seen only fleetingly over the past decade. The last time gold sustained ranges above \$400 in the late 1980s, core inflation consistently ran at annual rates of 4 to 4.5%. For now, though, we can only conclude that this cast of policymakers remains blind to these real-world risks, and appears hell-bent on relearning the lessons of monetary history only after it's too late. **TM**