TrendMacrolytics

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On Bernanke

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With gold today bouncing to 14-year highs above $420 and the dollar falling to new record lows against the euro, the market is now openly testing the limits of **the Fed's** "patience" for remaining on an inflation-biased policy track. Without a Fed response somehow signaling that it has gotten the market's message, the possibility of a speculation-fed dollar free-fall, with potentially ominous implications for all dollar-denominated financial assets, should not be ruled out.

Triggering this latest bet against the currency's purchasing power was yesterday's speech by **Fed Governor Ben Bernanke**, the latest in a series of such exercises suggesting the former **Princeton** economics professor, who has become a pivotal player in the Fed's policy councils, has but scant appreciation for the central bank's function in safeguarding the integrity of the unit of account. "For now, I believe that the Federal Reserve has the luxury of being patient," Bernanke told the **American Economic Association** in **San Diego**. "I think policy is currently quite accommodative. I think it can remain quite accommodative for a while to come."

Bernanke's self-assurance, obviously, is based not on sensitive, forward-looking monetary indicators capturing the dollar's shrinking real value but on such non-monetary factors as slack labor markets and strong productivity performance. Indeed, Bernanke acknowledged that "some remain unconvinced that the FOMC is pursuing the right course. Citing factors such as the rise in commodity prices and the decline of the dollar, a number of observers have warned that the Federal Reserve's policies risk re-igniting inflation."

In refuting that proposition, Bernanke suggested that the rise in commodity prices is "quite normal for this stage of the business cycle," and shouldn't mean much for inflation in any case "because raw material costs are a small portion of total costs." While noting the dollar's decline, Bernanke maintained that the forex value of the dollar is still stronger than its average in the 1990s, and suggested the potential inflationary impact of dollar depreciation appeared "relatively small" due to the "modest weight of imports in the consumers' basket of goods and services."

As suggested by the market response, these assertions amount to an entirely unconvincing set of rationalizations. Our economic model focuses on the behavior of gold, commodities and foreign exchange not because of their effect as inputs into costs but because, as sensitive readings of dollar strength, they are reliable indicators of future inflation. Unless corrected by subsequent policy change, a dollar falling in value relative to commodities and foreign currencies will eventually also fall relative to all goods and services priced in dollars -- meaning rising prices. One might have hoped that this was a lesson that wouldn't need to be relearned through repetition of policy error. In the early 1970s, similar assurances were made about the minor effects of dollar depreciation due to the relatively small share of imports in total consumption. In the event, of course, the decade of the 1970s is now recorded in economic history as the greatest era of inflation since the Civil War. TM

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