TrendMacrolytics

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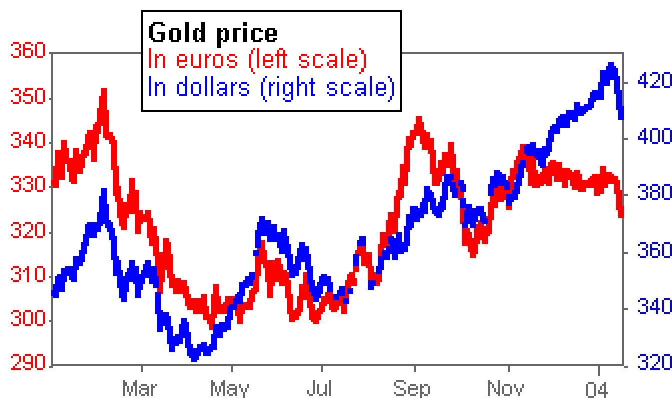
For all the fireworks last week, one truth remains: the Fed is too easy.

The dollar's 3 to 4% recovery against gold and foreign exchange late last week appears already to have run its course and is not likely to mark a turning point in the long-running erosion of the currency's real value. Last week's trading action came on speculation that the European authorities could move to confront an "overvalued" euro by depreciating it for export-competitiveness purposes. That brief dollar-buying boomlet, however, could not overcome signals from **European Central Bank** and finance officials overnight suggesting they have no plans yet to reverse the euro's appreciation against the dollar. With **the Fed** showing no sign that it is prepared to modify its excess-liquidity position, the path of least resistance for the dollar remains down. After falling from a record high last week above €1.28/$ to below €1.24/$, the euro in early afternoon trading was once again threatening the €1.26/$ level. Gold, meanwhile, was more than $6 higher to just below $413, having dived some $20 from 15-year highs above $425 last week.

Such intense volatility can be seen as one of the costs being imposed on the global financial system by the dollar surplus the Fed is fostering with its increasingly out-of-touch commitment to a 1% funds rate target. With the Fed's hyper-easy posture serving as the policy backdrop, a sure one-way winner the past three months has been the pairs-trade shorting the dollar against a stable euro while going long gold. In such a speculative climate, market prices can be subject to quick reversals on marginal information. Thus, when ECB officials last week were quoted musing on the "brutal" movement of the dollar/euro exchange rate, the knee-jerk market response was to bail on the pairs-trade and lock in some profit.



The chart at left offers a useful reality check on the notion that the exchange rate has in any way reflected an objective strengthening of the euro. Since October, as the dollar price of gold has soared from about $380, euro gold has been rock steady in a range around €330. In real terms, in other words, the euro's rise has entirely been a matter of dollar depreciation, not euro appreciation.

With European economies just barely out of recession and highly dependent on exports for whatever growth they can muster, speculation that the ECB will be forced to follow the Fed's lead to weaken the currency is not likely to subside soon. That's underscored by the fact that in all the cross-talk regarding the exchange rate, there is not the slightest recognition that the onus is on the Fed to apply some

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long-overdue restraint. Indeed, in a speech just last week **Alan Greenspan** remained firmly in denial that the dollar's weakening would have any inflationary consequences. Pressure could well build on the ECB to ease fairly aggressively in order to relieve the pressure on continental exporters who fear getting priced out of dollar markets. That's another potential cost of the Fed's inflation-biased posture: forcing other central banks to inflate their own currencies to keep from losing market share to dollar-based producers. It's the modern version of a very old and very dangerous game: competitive devaluation.

If the European Central Bank ultimately pursues an easy-money policy to play catch up with a weaker dollar, at some point it could well rein in the euro's appreciation *vis-à-vis* the dollar. That manipulation of the dollar/euro exchange rate would be entirely external, however, to the fundamental monetary forces that have been driving down dollar purchasing power, namely the Fed's open-spigot liquidity stance. In that situation, it's possible we could see the exchange rate stabilize as both central banks adopt more or less equally inflationary postures. The erosion of dollar's real value however, would show through in a rising dollar price of gold -- which remains the most sensitive indicator of supply/demand balance in the market for dollar liquidity. TM