TrendMacrolytics

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FED SHADOW

Don't Worry, Be Happy?

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Is the Fed inevitably facing the constraints of reality?

It's nearly universally agreed that the statement released tomorrow afternoon at the conclusion of **the FOMC's** two-day meeting will offer yet another rendition of the "don't worry, be happy" theme that the Fed has been playing since last summer. About the only suspense is how the monetary wordsmiths will frame their assurances of holding to a 1% funds rate for a "considerable period" in the context of an economy now expanding at rates rivaling the best days of last decade's boom. But in attempting to accommodate economic reality within the rationalization for its increasingly unreal policy stance, **the Fed** may well be nearing the limits of this exercise in policy extravagance.

Last month, while acknowledging that "the probability of an unwelcome fall in inflation has diminished," the Fed continued to insist that "the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal." But maintaining that perspective now would require a single-variable focus on payrolls as the paramount economic indicator, in as much as virtually all other readings of present conditions show the economy is embarked on an impressive expansion phase.

Yes, the December employment report released earlier this month came as a huge setback to those convinced that recovery would finally be reflected in sizable payroll gains, no doubt including many at the central bank. But is the Fed prepared to continue pinning its rationale for maintaining an excess-liquidity posture on an indicator that appears so clearly out of step with the preponderance of data pointing to broad-based acceleration, including other labor market gauges that suggest a healthy rebound in job creation? Is **Alan Greenspan**, for that matter, willing to risk putting his much-vaunted credibility in even greater jeopardy as he contemplates the legacy of his long tenure? If not, the props supporting the Fed's super-easy posture under the "unwelcome fall in inflation" rationale could give way significantly sooner than the market consensus now expect.

The mass of opinion that shapes that consensus ponders the latest statistical inflation releases, showing core price changes of about 1% year-on-year, and asks, "why worry?" Fact is, though, the effects of monetary policy show through in the data aggregates only after long and uncertain lags, and today's reported inflation reflects the policy stance of at least a year ago, and perhaps as much as two years ago.

More recently, of course, we have witnessed the steady erosion of the dollar's real value reflected in forward-looking market price indicators such as gold and foreign exchange, pointing to a period of appreciably higher -- not lower -- inflation. But the surplus liquidity being put into the market is also being borne out in Fed data capturing a growing oversupply relative to demand. In a market environment characterized by available returns well in excess of the funds rate target of 1%, upward pressure on the funds rate essentially is ever present, requiring the

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Fed to inject additional reserves more or less constantly to maintain the target. Over the past three months, the Fed has added reserves at annualized of more than 11%; the growth rate of the previous three-month period was just above 6%.

M2, meanwhile, which includes retail money market funds and saving deposits in addition to checking accounts and currency, can be considered a serviceable proxy for the demand for immediately accessible dollar balances. The latest data show that since mid-November, M2 has contracted at an annualized rate of nearly 6%, after growing at a 10% rate as recently as last summer. On one hand, the M2 reversal can be explained simply by rising opportunity costs: why hold balances tied to an unnaturally low Fed target when market returns are available for multiples of that rate? But that's also a way of saying that prevailing short-term rates are failing to compensate for the attendant risks, including current and expected inflation.

The mismatch between the Fed's increasing supply of liquidity through reserve injections versus the falling demand for money reflected in M2 is a manifestation of the Fed's over-easy stance. It should also be understood that as the Fed combats upwards pressures on the funds rate to maintain the 1% target, it is essentially further easing policy. This point was emphasized in a recent **St. Louis Fed** publication which, without specifically referring to current circumstances, could be read as a clear warning. If market forces "put pressure on the funds rate to rise, the FOMC must ease policy if it desires to maintain its existing funds rate target," says St. Louis Fed economist **Daniel Thornton**. "On the other hand, the stance of monetary policy is unchanged if the FOMC raises its target rate" in response to market forces. TM