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FED SHADOW

Anybody Home?

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There's a lot of talk about the dollar now -- all of it dangerous, and none of it right.

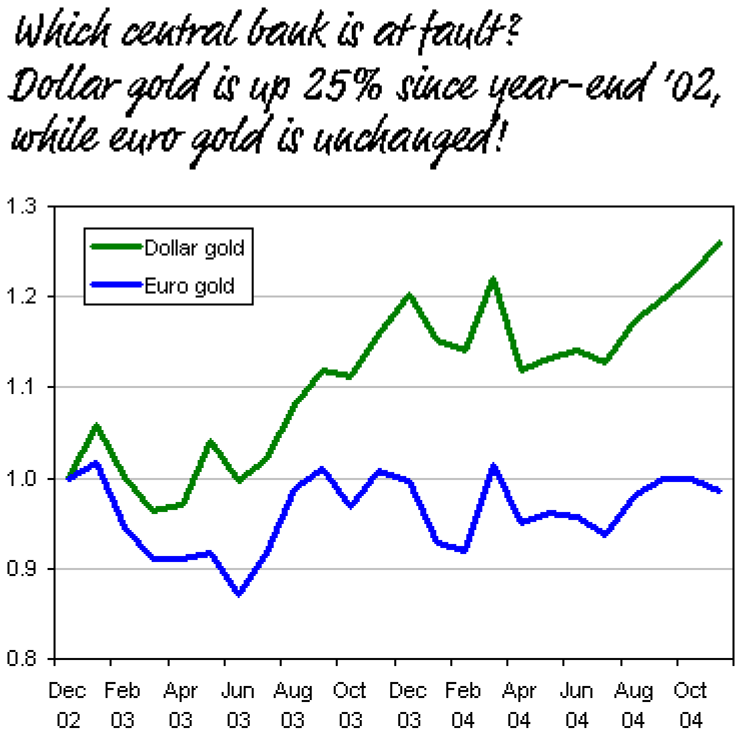
At its **FOMC** meeting last week, **the Fed** maintained its business-as-usual approach -- raising its overnight target rate another quarter point to 2%, and using its signaling rituals to indicate that its exercise in policy normalization would continue at a "measured" pace. Keeping no loose ends dangling, the FOMC also stated that "longer-term inflation expectations remain well contained," and stuck with its familiar boiler-plate language that upside and downside risks to both continued growth and price stability are "roughly equal."

Against this untroubled perspective, bear in mind that the dollar has declined by more than 5% against its major currency counterparts in just the last six weeks, and by more than 10% against gold -- the closest monetary proxy in the commodity universe -- since early September. Yet the Fed is content to broadcast that it sees no more risk of inflation turning higher than it does of the economy slipping back into recession. Not surprisingly, after stabilizing briefly following the FOMC's mid-week meeting, the dollar resumed its slide, with spot gold in overnight trading today breaking $440, and the trade-weighted dollar hitting new nine-year lows. It has become increasingly clear that Fed complacency is now a factor boosting inflation expectations and risk.

Prior to last week's meeting, we suggested that "a key question that stands to be answered by this afternoon's post-meeting statement is whether the central bank recognizes the dollar's policy implications, and somehow signals that it is prepared to act on them" (see "FOMC Alert" November 10, 2004). Having answered that question in the negative, it could be that the Fed is willing to countenance the dollar's accelerated depreciation under a handful of misguided notions now competing for attention.

The latest entrant in this contest of bad ideas holds that the weakening dollar is a not a manifestation of the Fed remaining too easy, but rather of other central banks, particularly the **European Central Bank**, being too tight. In other words, the euro's rise from about $1.20 in late summer to just below $1.30 is mostly a matter of euro appreciation, not dollar depreciation. This assertion does not hold up to scrutiny.

It's true that in a world of fiat currency regimes, simply looking at currency cross rates can be a highly misleading exercise. In the abstract, it's impossible to know whether the euro's gain of nearly 10 cents against the dollar these past few months has reflected a greater excess of dollars or an increased scarcity of euros. That's why it's critical to ground such an analysis in a real variable proven to hold its value over time and across currencies. In our model, gold thoroughly serves this function as a monetary indicator *par excellence*. A sustained weakening from equilibrium levels in a currency's value relative to gold is a sure sign of liquidity surplus and ultimately a decline in broad purchasing power. By the same token, a persistent appreciation of a currency reflected in a declining gold price augurs gathering deflationary pressures.



From that perspective, it's clear that the problem here lies with the dollar and the Fed, not the euro and ECB. The chart at left indexes the dollar and euro gold prices to their levels at year-end 2002; at that time dollar/gold was trading around \$350, which we consider a rough approximation for long-term price level equilibrium. Since then, while the dollar has depreciated by some 25% against gold, the euro has remained remarkably stable. Contrary to reflecting a deflationary, too tight policy stance, the euro gold price today, at about €337, is almost precisely where it was at the end of 2002. And while in the late 1990s the European monetary authorities made the mistake of following the Fed's deflationary lead for a period of time, the current euro gold price is some 10% above the levels seen prior to that episode. While the Fed is still overcorrecting for its deflationary error, the young European central bank is establishing an enviable record of monetary stability.

The real danger of such reckless reasoning -- suggesting that a weakening dollar is not what it seems -- is that it could feed the natural inclinations of policy makers who appear only too willing to seek a rationalization for the currency's decline. We have noted that **San Francisco Fed president Janet Yellen** recently maintained that policy should offset the growth drag occasioned by the effect of a "high dollar" on the trade balance. While Yellen is not yet regarded as a leading light of the Fed's intellectual consensus, the record of the Fed's September meeting released Friday offered no comfort in this regard. In it, policymakers cited the "worrisome widening" of the current account deficit as among factors that could weigh on the growth outlook.