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FED SHADOW

The Fed's Oil Slick

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Record crude prices mean a monetary mistake could be not just dumb, but disastrous.

Now that the Treasury market has finally awoken to a reality that it spent months studiously avoiding -- with a big assist from **the Fed** -- is the Fed itself poised to follow suit? Or will policymakers preparing to gather for tomorrow's **FOMC** meeting ignore the altered risk environment and content themselves that all is copasetic, requiring no change in their policy profile? Even with the universally anticipated move in the funds rate to 2.75%, the Fed's target will still sit well below equilibrium levels amid mounting indications that a shift to a more aggressive posture is overdue. Absent signs, at least rhetorically, that the Fed is cognizant of the changes bearing on the policy setting, the risk of additional real dollar weakness, exacerbating the inflation error already coursing through the system, remains real.

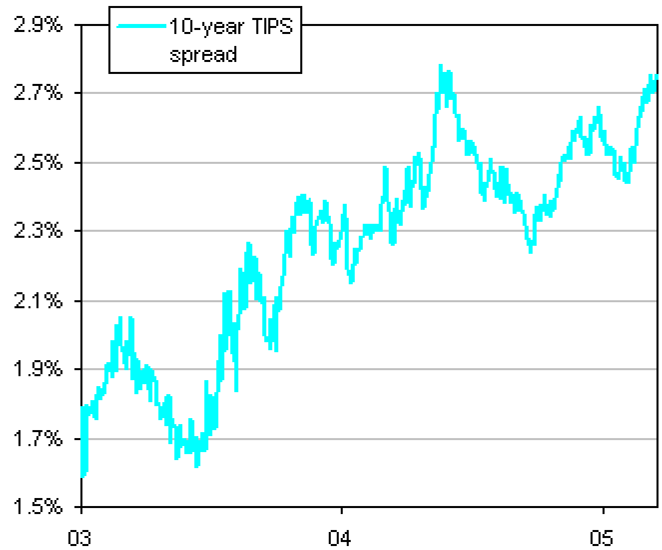
The most obvious alteration in the landscape being surveyed by the Fed, of course, is the $10 jump in crude oil prices since its last meeting in early February. No doubt, there are those at the Fed who subscribe to the demand-based view that higher oil prices constitute an economic drag, and that offsetting the drag means leaning toward keeping policy easier than it would be otherwise. Prominent voices in the economic establishment who subscribe to that view believe the Fed should not push the funds rate much above 3% unless crude prices reverse.

There also are figures at the Fed who see the oil price bulge as likely to be temporary and thus having little relevance for policy one way or another. They derive comfort from the notion that because inflation expectations have been "well anchored" during the oil market turbulence of the past year, higher crude prices pose less of an inflation risk. This reasoning also accords with the idea that since the oil price moves have apparently been marked by significant speculative excess, they are not a "fundamental" factor that need be of particular policy concern.

In our view, these are wholly unconvincing rationalizations for avoiding needed action. The first thing to bear in mind, as we have noted, is that oil already includes a significant inflation component, as seen in the 25% differential between the price escalation in dollar versus euro terms over the past two years (see "The Conundrum Unravels" March 15, 2005). However, the degree to which oil and other sensitive commodities reflect dollar inflation is being almost entirely overlooked -- which could end up sowing the seeds for compounding the error. If the Fed, unmindful of the inflation factor, maintains a too-easy stance given current conditions, it risks accommodating the oil price increase, further weakening dollar purchasing power and leading to more inflation -- and even higher oil prices -- down the road. The lessons of history in this regard should be obvious: in the 1970s, the Fed accommodated a rising oil price, and the worst inflationary era in **US** economic history since the Civil War was the result.

It provides small comfort to note that senior Fed officials at the time -- including chairman **Arthur Burns** -- were using arguments very similar to those being heard now to justify using policy to offset the contractionary influence of a higher oil price. Certainly, we don't dispute that

$56 per barrel crude is not economically optimal. Thus far, however, the economy has evinced little difficulty adapting to the escalating price trend the past two years. Moreover, to the extent that crude prices represent a weak dollar phenomenon, a more forceful transition to a non-accommodative monetary stance would strengthen the dollar and exert downward pressure on the price. On the other hand, allowing higher petroleum prices to become a justification for keeping the Fed behind the curve risks an inflation breakout that would ultimately bring a panicked policy response and surely put the expansion at risk.



At this point, it would seem the evidence is clear enough at least to point the Fed toward a less Pollyannaish posture in its post-meeting statement. Obviously, the credibility of its boilerplate assessments that upside and downside inflation risks are "roughly equal," and that policy accommodation can continue to be removed at a "measured" pace with "underlying inflation expected to be relatively low," is becoming increasingly dubious. The 10-year TIPS spread, a measure of inflation expectations that the Fed itself often cites, is now at 275 basis points and has widened by about 30 bps with the most recent oil price move. One would think that the coincidence of the crude price run up and bond market reversal starting the second week of February has not entirely escaped the attention of the central bank. Nor, for that matter, the **Beige Book** report from the Fed's regional reserve bank districts released earlier this month, which indicated that producers are increasingly successful in passing through their rising costs.

As of yet, though, there is little to suggest that the Fed is prepared to signal a significant change in the policy outlook. We suggested earlier that Fed chairman **Alan Greenspan** seemed to be acknowledging a higher degree of inflation risk, but there has been little follow up (see "Is Greenspan Getting It?" March 8, 2005). With its recent emphasis on transparency and predictability, it's likely that any substantive shift would be more explicitly telegraphed. If anything, though, it seems that more weight is being attached to not rocking the boat. Last week, **John Berry**, the ***Washington Post's*** old Fed hand who is now a **Bloomberg** columnist, published a piece suggesting officials "see little to worry about." In an article that contained no mention of oil prices, Berry extensively quoted the views of Fed governor **Ben Bernanke**, who views policy from the flawed "output gap" framework that treats inflation not as a monetary phenomenon but as a consequence of real factors such as capacity constraints and labor market tightness. "My own judgment is that some slack remains in the U.S. economy, although that slack is diminishing as growth continues above its long-run trend," Bernanke said.

Bottom Line: It is views such as Bernanke's, largely overlooking the crucial function of policy in determining the value of the unit of account, which have been responsible for repeated monetary missteps through the years. If the Fed is as oblivious to the current risks as Bernanke's comments suggest, it is perilously close to initiating an inflation upsurge larger than the present mild bump, which we forecasted eighteen months ago. Such an upsurge would have far greater deleterious consequences for the economy and the markets than any we have been discussing so far.