Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Deflation and Inflation: A Delicate Balance

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David Gitlitz

Deflation-fighting is the Fed's Job One now -- unfortunately its best weapon is inflation.

Update to strategic view
US MACRO: The Bernanke Fed will do whatever it takes to rule out any possibility of deflation taking hold, and likely is prepared to accept some inflation as the tradeoff in doing so.
[see Investment Strategy Dashboard]

In the face of mounting concern that the economy faces a potentially calamitous slide into a deflationary spiral, the price of gold has rallied as much as $130 off its lows earlier this month, and the dollar's forex value has sunk precipitously, off more than 10% against the euro. As we predicted they would in a report on Wednesday, both markets are presently consolidating those large moves (see "'Some Time' A Great Notion" December 17, 2008). Nevertheless, monetary deflation is experienced as a sustained appreciation of the purchasing power of the unit of account, so these indicators showing such a sharp erosion of purchasing power would seem to render deflation worries far-fetched.

But it cannot be ignored that real deflationary impulses, seen in the rush to cash spurred by the ongoing intermittent episodes of intense risk abhorrence, remain apparent (see "Why Isn't Gold at $1500?" December 10, 2008). Following the FOMC's announcement Tuesday of measures to maintain the extraordinary expansion of its balance sheet and flood the market with dollar liquidity, gold shot higher by some $30 and the dollar fell from 1.37 to 1.44 versus the euro. But in a fresh round of severe risk aversion, as seen for example in the three-month T-bill yielding zero, those moves have all but been reversed since trading opened yesterday.

Still, it’s our bet that the ultra-accommodative stance of Fed policy will ultimately prevail, and that further substantial declines in the dollar's real value are inevitable. As Fed Chairman Ben Bernanke's academic reputation is based on his analysis of the destructive role played by the Fed's deflationary errors in the early stages of the Great Depression, it's safe to say he will spare nothing in endeavoring to ensure against such an outcome. As it is, the softening of dollar value in the several weeks since it reached its recent high indicates that the Fed was already well on its way to satisfying the market's demand even prior to Tuesday's action.

In this volatile, highly strained market environment, erring on the side of liquidity abundance can be rationalized as a short-run necessity. Certainly, it would not be worth the risk at this point to in any way restrict the supply of dollars relative to demand. It's also probably the case, though, that in Bernanke's current ordering of priorities, precluding any possibility of deflation ranks well

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

ahead of the necessity of avoiding inflation. Inflation is a phenomenon central bankers know how to deal with. Deflation terrifies them. If the price to be paid for preventing deflation is a bout of somewhat higher inflation, the bet here is that Bernanke is more than willing to pay it.

Bernanke may have gotten some political cover for that position this week from Greg Mankiw, Harvard economics professor and former chairman of President Bush's Council of Economic Advisers. On his influential blog, Mankiw advised that the Fed's next announcement should frankly state, "The committee recognizes that moderate inflation would be desirable under present circumstances. In particular, the overall level of prices a decade hence should be about 30 percent higher than the price level today. The committee anticipates keeping the stance of monetary policy sufficiently accommodative to achieve that degree of inflation over the coming decade."

That may be fine as far as it goes. A steady 3% annual inflation rate would not present great difficulty for the economy, although it would involve a substantial repricing of Treasury debt which is presently discounting for inflation being a nonfactor as far as the eye can see. It wasn't very long ago that getting inflation *down* to 3% was considered a great accomplishment. The problem arises, however, in thinking that policymakers are somehow capable of calibrating their policy actions to a desired inflation outcome. The fact is, the tools of policy are incapable of that kind of precision, and over the years the Fed has consistently erred in attempting to fit its policy to a specific inflation objective. In this market and economic environment, the Fed's stance might be consistent with a 0% inflation rate. Once the market stabilizes and the demand for money normalizes, there's no way of knowing whether the same policy stance would be consistent with 3%, 5%, or 8% inflation. A lot would depend on how quickly and at what rate velocity recovers. But given the volatility of velocity over the years, it would be futile to attempt to make that prediction.

One way of another, it seems very likely that the present deflation anxiety is likely to yield over some period of time to a new inflation reality. How quickly that happens and to what extent will depend on the course of events in relieving the crisis atmosphere still affecting the markets and on the Fed's actions in following through on the quantitative easing approach outlined in Tuesday's announcement. It could be that a continued sustained decline in the dollar and rise in the gold price will lead to some moderation in the Fed's approach. Given the enormous borrowing needs of the Treasury and the need to attract foreign investment, avoiding putting the currency on an indefinite path of depreciation could be a limiting factor. Still, the conclusion seems unavoidable that the current priority on fighting deflation will end up bringing about an episode of rising inflation.

BOTTOM LINE: The recent apparently inflationary weakening of dollar purchasing power seen in rising gold and the decline against foreign exchange is balanced against the fact that deflationary impulses remain evident in the strong safe-haven demand for cash driven by the market's risk abhorrence. In the final analysis, the Bernanke Fed will do whatever it takes to rule out any possibility of deflation taking hold, and likely is prepared to accept some inflation as the tradeoff in doing so.