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FED SHADOW

The Maestro's Golden Years

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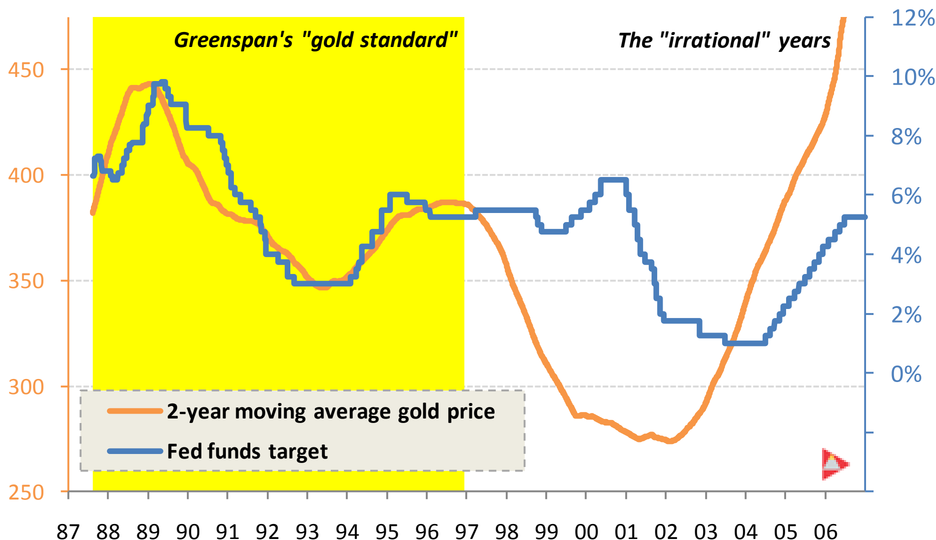
Greenspan belatedly returns to the gold standard, but the Bernanke Fed isn't following.

Update to strategic view

FED FUNDS: The Maestro has it right: gold at $1000 is a reaction to the market's increasing confidence that the fed will stay hyper-easy virtually forever, and its loss of confidence in the value of US paper currency.
GOLD: At some point a rising gold price can be self-correcting, spurring the Fed to reverse the inflationary error that caused the rise to begin with. We are nowhere near that point: the Fed is stuck on easy, and gold should continue to climb.

[see Investment Strategy Dashboard]

Former Fed chairman Alan Greenspan is alerting his former colleagues to the inflation risks they are currently courting in maintaining their exceptionally accommodative policy posture. And in a great historic irony, Greenspan's argument is: gold. Greenspan told a conference in New York this week that the recent rally in gold -- which poked above $1,000 this week for the first time in almost 7 months -- was a signal of the risk to the dollar in the current policy environment. Gold's rise -- as much as $77 in just the last month and more than $200 since early this year -- is "strictly a monetary phenomenon," Greenspan said. The rally in gold and other commodities is "an indication of a very early stage of an endeavor to move away from paper currencies."



As Greenspan well knows, there would be no "move away" from paper currencies unless the purchasing power of those currencies were being debased by their central banks. It used to be that Greenspan made no bones about his reliance on gold as a key reference point in his policy perspective. For

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most of the first half of his 18-year tenure at the Fed, policy was significantly guided by the gold price (specifically, during those years, the funds rate proportionately tracked the two-year moving average gold price, up and down, with near precision -- see the chart on the previous page). He abandoned the objective signal of gold around the same time that he began to exhibit enthusiasm for subjective abstractions such as "irrational exuberance." Because the gold price signal at that time would not have given him any corroboration for policy activism, he signed on to the demand-based prescriptions dictated by the fallacious "output gap" model. The deflationary recession early this decade was the short-term result -- and the inflationary housing boom and deflationary credit bust that followed were longer-term echoes of that same policy error.

Specifically, Greenspan could have spared the global economy and financial system much of its misery of the last two years had he been attentive to the gold price signal during his own hyper-accommodative phase in the last two years of his chairmanship. From mid-2003 (when Greenspan pushed the funds rate to 1%) through the end of Greenspan's chairmancy in January 2006, gold rallied by almost $230. He left office with gold at about $570, its highest level since 1981. The monetary excesses of that time laid the foundations for the bubbles in the credit and real estate markets that crashed so spectacularly the last two years. Although the Fed began lifting the funds rate in mid-2004, from a starting point of 1%, policy remained accommodative through the greater part of the rate normalization process. And throughout, the Fed was at pains to issue assurances that accommodation would be "removed at a pace that is likely to be measured." Even at the end point of 5.25% after two years, policy could not be characterized as objectively "tight."

Perhaps with some distance on his time in office, Greenspan has come to recognize his errors and believes his perspective could be valuable to his successors. If so, they show no signs yet that any such lesson has been absorbed. While the economy looks to be on its way to at least a muted recovery, the consistent message being put out by Fed officials is that there's still no reason to begin contemplating a reversal of its hyper-easy posture. That message is reflected in the renewed decline of the dollar, the rally in gold, and the drop to new all-time lows of tightening expectations in the fed funds futures markets.

To some extent, these responses may be a delayed awakening to reality, as all along the Fed has given no indication that it intends to back off its easy money posture any time in the foreseeable future (see "Bernanke's Second Act" August, 26, 2009). But the point is reinforced on every occasion when a Fed personage appears in public. That was the case this week when Chicago Fed's Charles Evans and the Dallas Fed's Richard Fisher took to the podium. Evans, at a speech before the Council on Foreign Relations, said any policy shift would be "some time down the road," and the Fed will be "looking very carefully at how the economic recovery is preceeding [sic]." In a separate interview the same day, he suggested that the reversal would not start before "unemployment starts coming down." Fisher said in a speech the risk to price stability was on the side of deflation, citing, in a typical output-gap rationale, what he sees as likely to be "a prolonged period of sluggish economic performance and uncomfortably high unemployment as businesses reallocate capital and labor to fit the new economic landscape."

The commodity rally and the dollar's forex decline could also be an indication that the heightened demand for money is easing in the context of reduced risk aversion. Against the euro, the dollar has been restored to around €1.46, last seen at the outbreak of the credit market panic last September which set off a deflationary flight to cash. As we have noted, relief from that extra increment of money demand will remove the major factor offsetting the Fed's profuse liquidity stance, which will leave the central bank's inflation-breeding posture exposed

unless an aggressive shift toward policy normalization is effected (again, see "Bernanke's Second Act").

Whether or not Ben Bernanke and his colleagues are inclined to give Greenspan's comments careful consideration, they could also ponder the implications of views expressed this week by a senior Chinese official, Cheng Siwei, former vice chairman of the Standing Committee. Cheng told a gathering at Lake Como, "If they keep printing money to buy bonds it will lead to inflation, and after a year or two the dollar will fall hard." Siwei said "most of our foreign reserves are in US bonds and this is very difficult to change, so we will diversify incremental reserves into euro, yen, and other currencies." He also suggested that "gold is definitely an alternative" to the dollar. China's concerns about the security of its dollar holdings is nothing new (see "China Calling" March 17, 2009), but Siwei offered a timely reminder of some of the stakes now at play. If the Chinese diversify their reserves into non-dollar holdings, that will make them less of a market for US Treasuries, with potentially significant repercussions for the yield that Treasury would have to offer to meet funding needs. As the US government's largest creditor, concerns of the Chinese certainly merit attention in their own right, but they can also be seen reflecting a more generalized risk to foreign capital arising from the potential for a serious policy mistake.

BOTTOM LINE: Alan Greenspan rediscovered his classical monetary roots, tying the gold price rally to the risk in holding dollars and as an indication of a "move away from paper currencies." So far there have been no indications that Greenspan's message is finding receptive ears at the Fed. At some point a rising gold price can be self-correcting, spurring the Fed to reverse the inflationary error that caused the rise to begin with. We are nowhere near that point: the Fed is stuck on easy, and gold should continue to climb.