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FED SHADOW

The Too-Big Easy?

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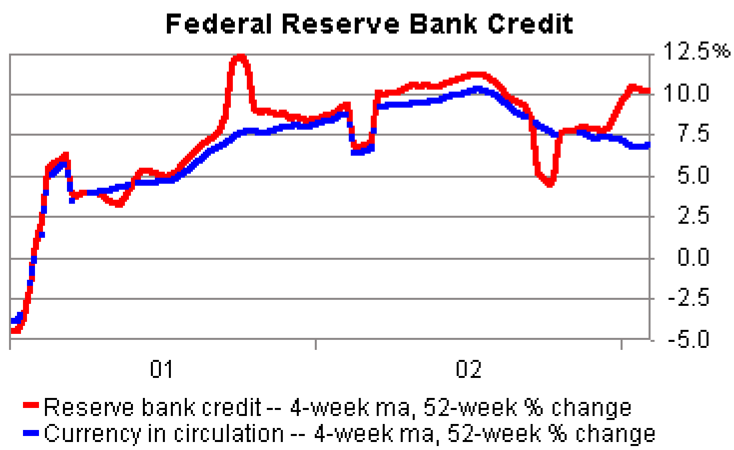
There's no inflationary impulse in the Fed's accommodative stance -- yet. But it's time to start watching.

With the dollar's rapid descent over the past two months to multi-year lows against foreign exchange, gold and broader commodity indexes, has **the Fed** found the "fix" for its belated acknowledgement of long-ignored deflationary conditions in a spurt of inflationary liquidity excess? The short answer is probably no, at least not yet. The question, though, is not nearly as out of place as it would have seemed just weeks ago, and is worth exploring in some detail.

Stocks mounted a modest post-**FOMC** relief rally late Wednesday on news that the Fed maintained its neutral policy bias, the supposition being that a shift reflecting renewed concern about weakness would have unnerved an already rattled market. If the dollar continues to decline at the rate that it has recently, though, the Fed would face some unpalatable choices that would not likely be a balm for the market's nerves: to tighten into a lackluster recovery, or to engage in benign neglect of a dollar sliding into inflationary danger.

In November, at the time the Fed first expressed concern about the possibility of "disinflation" morphing into outright deflation, we noted that the central bank's recognition of deflation risk came with the market's most sensitive price gauges already showing significant relief from an excess dollar scarcity. We pointed to the risk that if the Fed, with its penchant for "fighting the last war," trained its monetary guns on reversing deflation pressures that were already substantially subdued, a liquidity deficit could turn to a surplus, and inflation would inevitably result (see "A Deflation Dichotomy" November 18, 2002).



Since then, there's little doubt that the dollar has absorbed the impact of a significantly more generous Fed liquidity stance. In the weeks following the FOMC's early-November rate cut to 1.25% -- which coincided with its sudden attentiveness to deflation risk -- expansion of the Fed's balance sheet accelerated markedly. On a four-week moving average, year-over-year growth in Reserve Bank Credit -- reflecting the Fed's creation of liquidity through open-market securities purchases -- moved from less than 8% to nearly 10.5% by earlier this month, and now stands at about 10.2%. It's important to note, moreover, that this balance sheet expansion has come without corresponding growth in currency demand. The Fed routinely

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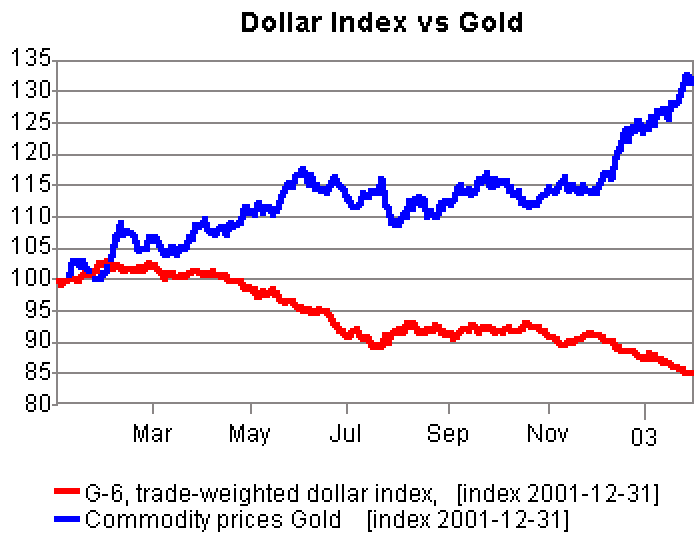
accommodates that demand as an essentially clerical function, and to the extent overall Fed credit is only growing in accord with currency in circulation, it does not reflect additions to discretionary reserve supplies. Currently, though, the overall balance sheet is growing at a rate some 45% faster than currency demand -- that's10.2% versus about 7% -- the largest such margin since the immediate aftermath of 9/11, when the Fed flooded the system with liquidity on a short-term emergency basis. After more than five years spent in an unrelentingly deflation-biased posture, there's no mistaking it: the Fed is easy.

Up to a point, of course, easy is exactly what is needed to secure the sustained reflation of the unit of account necessary to restore the market's willingness to bear risk, without which any economic expansion will remain sub-par. Obviously, though, given the long history of our central bank committing new errors in clumsily attempting to clean up its previous ones, it would be unwise during this period to ignore the risk of inflationary overshoot. Still, it's likely premature at this point to posit that the *potential* for inflationary error is already being realized. For one thing, the current geopolitical risk environment must be accounted for as a factor in recent movement of the market price indicators, particularly gold. Aside from its monetary properties, the function of gold as a safe-haven asset in times of extreme uncertainty is still relevant. The Iraq crisis is almost certainly responsible for some portion of the gold price run up to nearly $370 per ounce, from ranges around $320 in early December and the mid-$340s as recently as late last month.



It's difficult to say exactly how much of that move is attributable to geopolitical risk, and is therefore not likely to be sustained, but the attached chart plotting the gold price against the trade-weighted, G-6 index of the dollar's foreign exchange value provides some perspective. With both series indexed to year-end 2001, we can see that gold and the trade-weighted dollar followed similar paths during the past year. As is usually the case, the rise in the gold price -- the most sensitive of all monetary indicators -- led the dollar's depreciation through the bulk of the year, but not dramatically. Trading in the low $320s early last month, gold reflected a real dollar depreciation of about 15% for the year, while against forex the currency had declined by some 10%.

Note, though, that subsequently the gold price rocketed higher while the dollar index maintained its more gentle declining pace. Although alarms have been raised in certain quarters about the dollar's fall -- especially against the euro -- it's worth noting that the G-6 dollar index has only returned to its levels of late-1999 and early 2000, which represented an appreciation of nearly 17% from its position two years earlier. At these levels, in other words, the dollar simply reflects an unwinding of the worst of the Fed's deflationary errors, and is by no means in dangerously weakened condition. The relationship would suggest that once the safe haven flows into gold subside, gold should fall back into a range below $350, which would also represent little -- if any -- inflationary threat to the currency's purchasing power.

During such a period of heightened risk, however, one would hope that the full attention of **Alan Greenspan** could be devoted to maintaining confidence in the integrity and stability of the dollar. Instead, we have been treated to reports this week that the Fed chairman has huddled behind closed doors with members of the **Senate**, offering a skeptical review of **President Bush's** pro-growth tax package. These reports are particularly confounding because in this environment it would seem that the last thing Greenspan should want is to hobble fiscal policy and put an even greater share of the burden of recovery on the shoulders of monetary policy. TM