TrendMacrolytics

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FED SHADOW

FOMC: Moment of Truth

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Tomorrow's policy meeting could be pivotal in determining whether inflation risk becomes inflation reality.

With the price of gold in intraday trading Friday breaching the $390 plateau for the first time since mid-1996, tomorrow's meeting of **Fed** policy makers shapes up as a major test for **Greenspan & Company's** stewardship of the unit of account. Although any change in its 1% funds rate target is inconceivable at this point, the **FOMC's** post-meeting statement will be critical to the policy outlook at a pivotal moment. Should the FOMC, observing increasingly worrisome market price indicators, back away from its recent insistence that "the risk of inflation becoming undesirably low" is its primary concern, current risks could still be quelled without significant damage to dollar purchasing power. Otherwise, if the Fed sticks to its pledge to maintain a highly accommodative posture for a "considerable period" in its chimerical quest for a lower unemployment rate, the threat of an inflationary breakout would loom larger than ever.

Unfortunately, the pre-meeting signs are not propitious. Last Thursday, the ***Washington Post's*** veteran Fed correspondent **John Berry** wrote that the FOMC is "likely to release a statement similar to the one they issued after their September meeting saying they are more concerned about the possibility that the already low inflation rate will fall further than that economic growth will be too strong." Although Berry quoted no sources, he has long-standing tenure as the favored vehicle to carry messages the Fed's senior staff wants publicly disseminated, and his reporting can considered an authoritative reflection of the staff's position.

Indeed, Berry's story hews closely to the fallacious output-gap policy model so favored by the Fed's permanent bureaucracy. Despite the fact that its positing of real factors such as unemployment and capacity use has been repeatedly discredited as having any causal relevance to price level changes, the output gap remains the secular religion shaping the senior Fed staff's worldview. "At this point, Fed officials are not contemplating raising rates," Berry wrote. "Although the economy is growing more rapidly, the unemployment rate remains above 6 percent…In these circumstances, the Fed is likely to leave rates low until there is unmistakable evidence that significant, sustainable job growth is occurring…[T]hat may not happen until the second half of next year, or even early 2005."

In the real world, meanwhile, the most sensitive market gauges of the currency's real value all signal that the Fed is in an excess liquidity posture, increasing the risk to dollar holdings and putting the central bank on the brink of an outbreak of sharply higher inflation expectations. In addition to gold, the G-6 trade-weighted dollar index is back at levels last seen in early 1997 while the CRB spot commodity index has jumped 30% since the spring of last year and is now at six-year highs.

True, we have viewed the greater part of these moves in a positive light, consistent with the Fed adopting a reflationary stance to root out the deflationary impulses caused by its earlier posture

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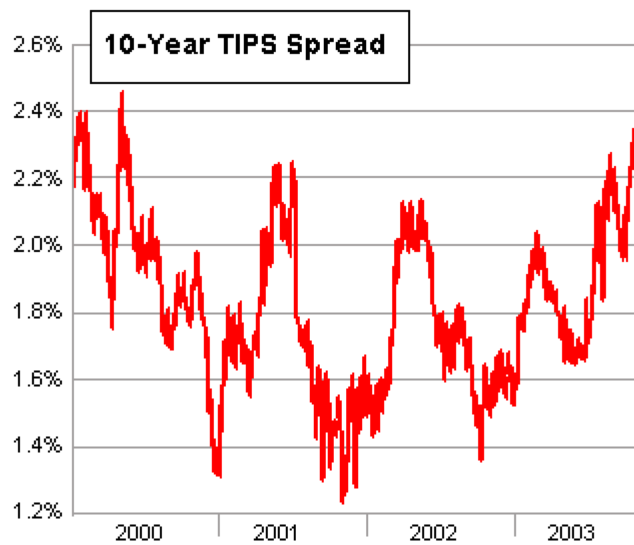

of extreme dollar scarcity. This, however, appears to be an inflection point, with the Fed's remaining margin for error sharply limited by the fact that it has fully reversed the earlier deflation, and then some. Continuing to maintain a reflationary course against non-existent deflationary impulses will inevitably result in inflationary error. And while the Fed's most senior functionaries may content themselves with their mathematical abstractions *proving* that rising inflation is impossible as long as labor markets remain slack, the market knows better. Since mid-summer, for example, the spread between nominal 10-year Treasuries and their CPI-indexed counterparts has blown out by some 70 basis points. How ironic that the current TIPS spread of about 235 bps puts that measure of inflation expectations at its highest levels since spring 2000, when the Fed was stubbornly committed to *raising* rates in battling against a too-*tight* jobs market. TM