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FED SHADOW

Desperately Seeking Inflation?

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Markets will have to deal with the possibility that Greenspan isn't just blind to inflation -- he actually wants it.

If **the Fed** succeeded in assuring the markets yesterday that it saw no need to contemplate raising rates for a so-called "considerable period," why are long-term Treasuries today taking such a beating, more than reversing their post-**FOMC** meeting gains? That's in contrast to the short end of the curve, where the 2-year note is holding on to part of yesterday's rally. At 4.3%, the yield on the10-year note is now 3 basis points higher than its level at Monday's close, after rallying to 4.18% late yesterday.

While it's always advisable to exercise caution interpreting the significance of one day's trading activity, today's action offers a telling glimpse into the inescapable realities of the Fed's increasingly brazen dalliance with inflation risk. For the most part, the performance of short maturities reflects the Fed's restated commitment to indefinitely maintain a 1% rate target. The length of maturity, however, compounds inflation risks, and long-dated issues cannot avoid the inflationary implications of the Fed's stance. Ordinarily, analyses of these FOMC proclamations is focused on ferreting out the central bank's "message" to the market, but in this case the *market's* message to the Fed is probably even more significant. Essentially, the market is signaling that the assertion -- repeated in yesterday's post-meeting statement for the fifth consecutive time -- that the risk "of an unwelcome fall in inflation exceeds that of a rise in inflation from its already low level" is no longer credible.

Indeed, it is now impossible to avoid concluding that the Fed, while casting itself as vigilant against the possibility of further "disinflation," is in fact consciously seeking higher inflation. As we have noted, even the federal government's lagging official indicators show that the directional trend in statistical inflation has turned higher over the past several months (see "Disinflation: Public Face vs. Private Reality" October 20, 2003). It strains credulity to posit that Fed officials are unaware of this trend shift, but it suits their purposes now to ignore it and present the Fed as endeavoring to fight deflationary influences, despite all market-based indicators of dollar strength showing those impulses have conclusively been rooted out. In fact such indicators now point to excessive dollar *weakness*. Gold, for example, has been flirting with decade-long highs, and was not mollified by the Fed's message: today it has gained back all of yesterday's pre-FOMC losses.

Confirmation of sorts for the proposition that the Fed is actually endeavoring to boost the inflation rate is provided by today's FOMC report by the ***Washington Post's*** **John Berry**. As we noted Monday, Berry's reporting can be regarded as an authoritative representation of views the senior Fed staff deems suitable for public consumption (see "FOMC: Moment of Truth" October 27, 2003). In today's story, Berry cites Fed officials as being concerned that the 6.1% unemployment rate "will probably put downward pressure on core inflation, which is running at only about a 1 percent annual rate." (Actually, over the past three months core CPI has risen at a 1.5% annual rate, while the core personal consumption deflator is up at a 2% rate.) "The officials would like to see the rate somewhat higher so that a shock to the economy…would be less likely to cause prices of goods and services to fall on a broad front, a condition known as deflation."

Berry refers to the possibility of another terrorist attack as the potential deflationary "shock" now motivating the Fed to countenance higher inflation, but we are dubious that that is the Fed's primary concern at this point. Our hunch is that **Alan Greenspan** is preparing for the inevitability of rate-hiking down the road, and wants more of a "cushion" in the inflation rate before entering a tightening mode. Greenspan likely would be significantly more comfortable embarking on a course to push rates higher with core inflation in a range of 2% to 2.5% than in a range of 1.5% to 2%. While "the maestro" spent years in denial about the deflationary forces unleashed by his policy errors of the late 1990s, the long-delayed reckoning with that reality appears to have left the chairman permanently scarred. At this point, leaning toward somewhat higher inflation in the short run is a price Greenspan seems willing to pay in order to avoid the maw of deflation risk.

We'd have little problem with statistical inflation stabilizing in a range around 2%. Given the methodological distortions inherent to the official indexes, such a rate would be virtually indistinguishable from effective price stability. If that comfort zone keeps Greenspan's deflation angst in check, so be it. The problem is that the Fed's rate-targeting procedures are an extremely imprecise mechanism for calibrating to any given inflation rate. Moreover, the lagging nature of the inflation indexes which the Fed monitors for policy feedback compound the potential for error. In the event, by the time the Fed is satisfied that it has reached an inflation objective of 2% - 2.5%, the attendant inefficiencies could well embed errors that would result in a jump in the actual price level double that. Such are the uncertainties that the market must now discount given the central bank's perplexing and dangerous flirtation with the inflationary sirens.
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