

FED SHADOW

Clinging

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Even after March's terrific jobs report, the Fed still just doesn't get it.

After its abrupt appreciation against gold and foreign exchange on release of the expectations-shattering March employment data, the dollar has quickly settled into ranges only marginally stronger than its softest pre-report levels. Yes, the blistering jobs numbers -- which showed payrolls growing at an annualized rate of 2 million in the first quarter -- had the salutary effect of moving forward the expected date of **Fed** action to begin correcting its surplus liquidity position. But with gold in a range around \$420, the dollar's value in gold terms is stronger only relative to gold's above-\$425 close in the two sessions prior to the April 2 release, and has fallen nearly 30% since gold traded around \$325 a year ago. Against the G6 trade-weighted dollar index, the dollar shows similarly slight gains and remains within 5% of the eight-year lows reached in mid-February.

These market prices are among the most sensitive, forward-looking indicators reflecting continuing skepticism that a policy shift will come soon enough -- or forcefully enough -- to avert a potentially damaging acceleration of the general price level. That sense of doubt has hardly been quelled in the past week as Fed officials continued to cling to job market uncertainty as a crutch for an exceedingly accommodative stance. Under the archaic notion that a supposedly "slack" labor market constitutes a disinflationary influence, the Fed seems fixated on keeping faith with its assurances to remain "patient" while overlooking the gathering threats to the real purchasing power of the currency.

For **Fed Vice Chairman Roger Ferguson**, the burden of proof remains on establishment payrolls to demonstrate that "a shortfall of aggregate demand relative to the economy's potential, ...an important part of the rationale for the currently accommodative" policy stance, has been overcome. Ferguson, in [a speech](#) at the **San Francisco Fed** last Thursday, offered what amounted to a straightforward acknowledgment that monetary policy is now engaged in a single-variable quest for job growth. While recent data has been "encouraging and may signal that the recovery in the labor market is gaining traction," Ferguson said, "one cannot definitely rule out the possibility that hiring will fall short of expectations over the next several months." Thus, the question of whether the labor market recovery is "fundamental and durable will take some time to answer," Ferguson told the group, and "remains at the top of my list" of policy concerns. Ferguson is regarded within the Fed as a staunch ally of **Alan Greenspan**, and his thinking can usually be regarded as being closely aligned with that of the Fed chair.

One might have expected a somewhat different note to be sounded by **St. Louis Fed President William Poole**, whose intellectual background in the monetarist tradition at least provides him with an understanding of inflation as a monetary phenomenon. But there was little separating Poole from the aggregate-demand targeters in remarks last week to the **University of Arkansas**. Indeed, Poole sounded much like Ferguson when he suggested that while the March employment report "was very good news...it's going to take some string of months" to know

whether the jobs drought is finally over. Even more dubious, however, was Poole's characterization of the surge in commodity prices and the dollar's decline against foreign currencies as "noise" with which the Fed need not be particularly concerned. Lumping these together under the so-called "supply-chain view" of inflation, Poole asserted that "we just cannot reliably conclude that today's materials prices inflation will be tomorrow's finished goods inflation...Nor are exchange rate depreciations necessarily leading indicators of price changes at the retail level. The U.S. remains a relatively closed economy with a large fraction of the goods and services consumed here produced domestically."

This path of reasoning, however, exposes Poole's blind spot, which is no doubt widely shared within the Fed system, in failing to appreciate -- or even comprehend -- that the value of the unit of account is a critical function of policy. We do not view the behavior of foreign exchange, gold and other commodities as cost-input factors, but rather as key indicators of the effects of policy on the dollar's purchasing power -- what it will buy in exchange. When the dollar is falling in value relative to a broad cross-section of these indicators -- as it is now -- it's a virtual certainty that the explanation lies in an excess supply of dollars relative to demand. Without corrective action to rebalance the supply and demand for dollar liquidity, eventually the effects of a cheapening unit of account must feed through the price system. A dollar falling in value relative to the goods and services priced in dollars is the definition of inflation.

The early signs of that process are already becoming apparent, as seen in today's front-pager in the *Wall Street Journal*, "Price Increases In Asia Fan Inflation Fears In U.S." The story describes the upturn in consumer prices being experienced in economies such as **China** and **Hong Kong** "boosting the odds that inflation will be exported to the U.S. and elsewhere in the months ahead." In fact, though, it's more accurate to say that these markets are now *importing* the inflationary effects of US monetary policy. With their dollar-pegged currencies, these Asian economic powerhouses can be thought of as the 13th and 14th districts of the Federal Reserve System. With their shorter contract lengths and debt maturity structures, the effects of policy are transmitted through the price system much more rapidly than they are in the US. As seen in the chart above, the Chinese price level was in outright decline through 2002, owing to the dollar's deflation -- and since then has closely followed the reflation seen in the dollar price of gold. **IM**

