TrendMacrolytics

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FOMC Alert

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The world awaits confirmation of another quarter-point rate hike and whatever hints the monetary masters care to provide about their outlook, but there's more riding on this meeting than whether **the FOMC** shades toward another 25 basis point bump in the funds rate next month. The added magnitude is underscored by the fact that since **the Fed's** last policy-making session in September, the dollar's trade-weighted forex value has fallen more than 5%, matched by the price of gold breaching the $435 level for the first time in 16 years.

Despite finally embarking on the path of policy normalization at mid-year, the dollar's continued descent offers clear testimony that the Fed remains badly behind the curve. So a key question that stands to be answered by this afternoon's post-meeting statement is whether the central bank recognizes the dollar's policy implications, and somehow signals that it is prepared to act on them. Without such an acknowledgement, the dollar's recent descent could be extended, signaling potentially serious inflationary outcomes.

Make no mistake: while the supposedly dollar-depressing effects of current account and budget deficits are the leading rationalizations offered up by the conventional wisdom to explain the dollar's troubles, its decline is at root a *monetary* phenomenon, reflecting an excess supply of liquidity relative to demand. From a short-term trading perspective, extraneous factors such as deficits can influence the speculative environment taking the dollar lower. But such speculative opportunity can arise only against the backdrop of a too-easy monetary policy stance. If trade deficits caused currency weakness, the relationship surely would have been borne out in the period between late 1996 and early 2002, when the current account deficit ballooned from $22 billion to more than $110 billion. Instead, with the Fed keeping a deflationary vice grip on liquidity availability, the dollar appreciated by some 40%. As for the notion that currency depreciation can be viewed as a reliable corrective for trade imbalances, Fed ease has reflated the dollar by 30% since the first quarter of '02 even as the current account has fallen a further $56 billion into deficit.

As for the popular "twin deficits" theory under which budget deficits supposedly act to foster trade imbalance and pressure the dollar, the connection is equally undetectable in the data. Through the 1990s, the budget deficit fell and eventually turned to surplus as the current account deficit rose. In 2000, the budget surplus stood at 2.4% of GDP and the current account deficit was 4.4% of GDP; in 1998, when the budget first went into surplus accounting for 0.8% of GDP, the current account deficit was 2.5%.

Although it would seem that safeguarding the integrity of the unit of account is a central task of any central bank, a threshold question concerns the degree to which Fed officials regard the dollar's fall as an issue that should even enter into policy considerations. In fact, the dollar's recent accelerated decline dates to late September when various central bank figures went on the record broaching the prospect of currency depreciation. One, **San Francisco Fed president Janet Yellen**, explicitly suggested that policy he kept easier in order to offset the

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growth-depressing effects of the trade deficit resulting from a "high dollar" (see "Dollar Delusions" October 26, 2004). In that vain, former Fed governor **Larry Meyer** suggested on **CNBC** this morning that the Fed "wouldn't want to influence the dollar," because the currency's decline is seen as part of the process of "unwinding serious global imbalances."

At the same time, however, the central bank could take a step toward currency stability if it acknowledges today that the pace of economic expansion has accelerated, perhaps inspired by Friday's payroll jobs report -- which revealed not only robust job growth in October, but also significantly upward revisions to growth in August and September. Such an acknowledgment from the Fed would suggest that moving forward, the outlook favors a more, rather than less, assertive route to policy normalization. As we noted previously, the dollar's softening since last spring coincided with a substantial unwinding of out-month rate-hike expectations (see "Bond Illusions" September 23, 2004). Were those expectations to significantly reverse once again, further downside risk to the dollar would at least be curtailed. TM