Domestic Research
Polyconomics, Inc.

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A DISCUSSION ON FED FUNDS TARGETING

We have, as you know, been taking an unconventional position against the Fed's decision to raise the federal funds rate in order to pre-empt a new monetary inflation. Our belief has been that a higher funds rate would not put any downward pressure on the dollar price of gold and, if anything, would work in the opposite direction. At its recent high of $430, gold is now about $50 higher than it was when the FOMC signaled it might soon begin raising the ff rate from its low of 1%. The rising price of oil and weakening economy, we believe, has been the cause of gold's rise, as a declining demand for liquidity is not dealt with by the Fed's operating mechanism. With less demand for a given supply, in the first instance the dollar loses value relative to gold, which produces an incipient inflation.

One of our longtime clients, Scott Grannis of Western Asset Management, took issue with our reasoning in an e-mail ten days ago, and an exchange of views quickly followed. Eventually, Wayne Jett our West Coast representative offered his thoughts, and so did Paul Hoffmeister, our chief market strategist whose October 7 client letter helped kick off the discussion. The discussion is still open, but I thought it interesting enough to share with you, and Scott said it would be okay with him. I'm also sharing this with a few Fed governors who have been open-minded to our offbeat missives.

From: Scott Grannis
To: Jude Wanniski Subject: Oil and gold
Date: Fri, 15 Oct 2004 15:05:38

Jude, my reading of the oil and gold markets is somewhat different from yours. You say that higher oil prices will hurt the economy and that will reduce the demand for dollar liquidity, and that is what is pushing gold higher. I also think higher oil prices will potentially hurt the economy, but the more important link is to Fed policy. Since high oil prices are a problem for the economy, the Fed's model of inflation tells them that higher oil prices are disinflationary, so they will tighten less than they otherwise had planned, and it is the prospect of a prolonged period of accommodative monetary policy that is pushing gold higher and the dollar lower. The bond market and the Fed heartily embrace the theory that what is bad for the economy is good for bonds. The Fed is still quite accommodative in my book. Check out the correlation between Sep '05 eurodollar contracts and gold.

From: Jude Wanniski
Sent: Friday, October 15, 2004 3:22 PM
To: Scott Grannis

Scott... I agree with you completely that Fed policy is too loose, which is why gold is at $420. I disagree with you that the price can be driven down by raising the ff rate. There is no theory I know about that says it can be accomplished with anything less than a Fed commodity target... draining reserves from $420 gold to a lower target. Did you read Hoffmeister's paper this week? I don't know why there should be a disagreement between you and me on this topic. Can you tell me when it was that you decided a ff target to manage output was the correct thing to do, and why? The theorem seems to have dropped from the sky... because supply-siders in particular had pooh-poohed the arguments I have been making since 1997 that we were in a monetary deflation. In order to have a model that doesn't accept my arguments (which I learned from Mundell), they have latched on to the idea of a Wicksellian natural rate and jumped from there to a natural ff rate. How can you square all this? Please, Scott, give this serious thought and come back to me. I do feel embattled, but cannot find anyone willing to engage me on the fundamentals. They simply say: The ff rate must go up and up and up, to ???

From: Scott Grannis
To: Jude Wanniski
Date: Mon, 18 Oct 2004 11:48:07

Of course the gold price can be driven down by raising the funds rate. The Fed just has to raise it by enough - whatever that happens to be. My guess is that we would need a funds rate that is at least 3-4% before gold would take a hit, but who knows. If the Fed adopted a gold/commodity target, they would have to do exactly this: start moving the funds rate up until gold/commodities started to weaken or get back down to their target levels. At some point a higher funds rate would have the effect of "draining reserves" even though that might mean that reserves simply stopped increasing. (I sent a message to Hoffmeister on this same issue last week, by the way.)

I don't believe in a ff target. I believe the Fed should be on a dollar/gold/commodity price target, however they want to define it. I believe they shouldn't be paying attention to the output gap, and instead should be paying attention to sensitive prices, which are all saying that the ff rate is too low. They need to raise it more, and they need to tell people why. Once they found the rate that arrested the reflation process that is underway, they could then perhaps find that the ff rate could be lowered without doing any damage.

I was completely in agreement with you about the Fed's monetary deflation that was set in motion in the late 1990s, and that is why I am now concerned that the Fed is generating a rising inflation rate. I'm looking at the same indicators now that made sense back then: real interest rates, gold, the dollar, commodity prices, the shape of the yield curve, and credit spreads. I don't agree with Kudlow's Wicksellian natural rate argument, especially since he seems to find it in the TIPS market. I look at TIPS quite differently. I've told you before that I don't believe in a fixed or natural rate. The only rate that makes sense is the one that delivers price stability, and that is a rate that is likely to fluctuate over time.

From: Jude Wanniski
Sent: Monday, October 18, 2004 12:08 PM
To: Scott Grannis

Scott... When you say "of course" the gold price can be driven down.... You say "of course" like it was akin to the law of gravity.... And I don't know of any theory that explains why a higher funds rate will cause gold to go down rather than go up or not do anything at all. In the good old days of the gold standard, the Bank of England could break speculative fevers that believed a devaluation was in the offing by raising the discount rate... and when speculators saw they were going to lose their shirts by betting against the Bank, they covered their shorts and skedaddled. This new mechanism that you cite, raising the ff rate to 3-4% so gold takes a hit doesn't have the same kind of logic going for it. We can just as well imagine gold going higher and the yield curve shifting up along with funds, as it has so far. Sure the effect may be to stop adding reserves or even draining reserves, but what if the effect has been to decrease the demand for reserves even more? This is all iffy, I admit, but I just can't see your "of course."

PS Mundell gave a talk in Europe last week suggesting a move back to gold... as a step toward a global currency.

From: Scott Grannis
To: Jude Wanniski Subject: RE: Oil and gold
Date: Mon, 18 Oct 2004 12:33:48

The Fed has three options for managing monetary policy. They can target an interest rate, they can target reserves (or one of the Ms), or they can target the dollar; all with some objective in mind, whether that be low inflation, stronger growth, or whatever. I'm assuming they stick to targeting the ff rate, but their objective shifts to bringing down the price of gold in order to bring down the rate of inflation. I firmly believe they could bring gold down by targeting the ff rate. The problem with this approach is obvious, because no one knows what the right ff rate would be that would bring gold back to your magic $350. But they could easily experiment, as they do now, by raising it until gold began to respond. This approach is essentially equivalent to draining reserves directly, or slowing the growth in reserves, in order to bring gold down. If they abandoned their ff target mode and started squeezing the market for reserves, I have to believe that the market ff rate would rise. If I'm not mistaken, the analogy for what I'm describing is a monopoly producer (a) raising the price of his goods until he sees demand falling off to more closely match what he is comfortable supplying, or (b) withholding supplies of his goods until he sees the price rise to a level he is comfortable with.

Whatever the case or the analogy, there must be a ff rate that would have the effect of making reserves scarce relative to the demand for reserves. That's why I say "of course." There must be a level of interest rates today that would convince the market that it would be better to sell gold and buy bonds. By the way, the more I learn of the bond market, the more convinced I am that the Fed effectively controls the Treasury yield curve all the way out to 10 years. The curve is a function of where the market thinks the ff rate will be in the future, pure and simple.

From: Wayne Jett
To: Jude Wanniski
Subject: Re: Scott Grannis
Date: Mon, 18 Oct 2004 13:41:01 -0700

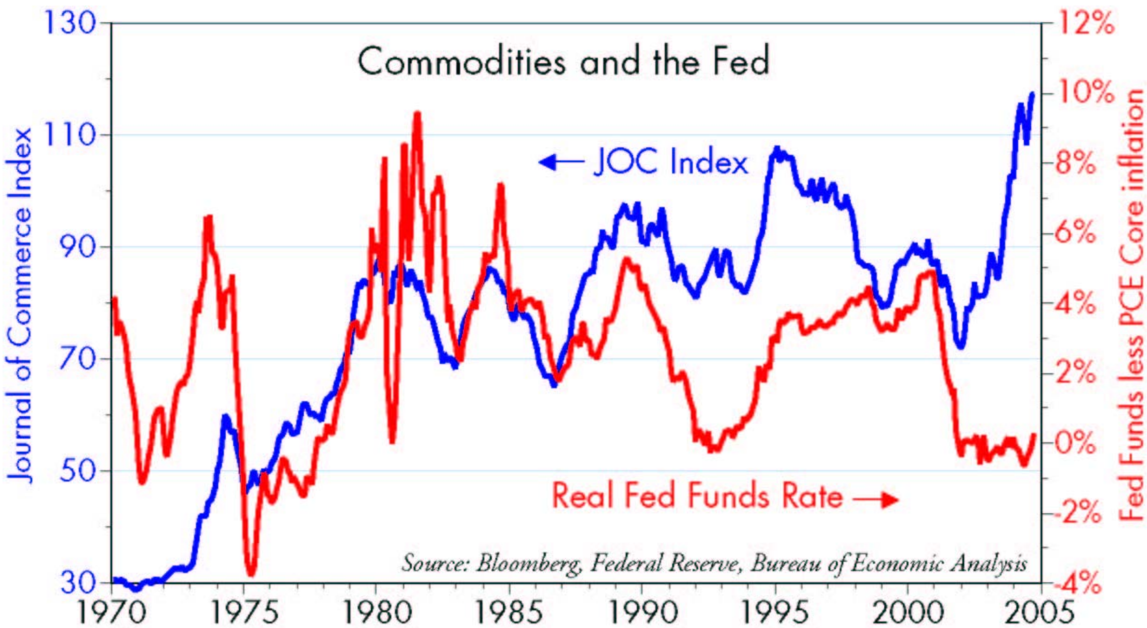
I think Scott's premise that an ff rate exists which would achieve the equilibrium price of gold is incorrect. As you have noted many times, only one variable can be targeted and controlled at a particular time; the market causes all other variables to adjust to the conditions that have been produced to achieve that target. So the price of gold (i.e., the value of the dollar) would still be subject to variation depending upon all other variables. Therefore, as other variables change, the price of gold would change, unless the ff again changed in turn. That is precisely the conundrum we have now. In order to try to achieve dollar/gold stability, the ff rate would have to be changed continuously by the Fed. The Fed is incapable of doing that efficiently; only the market can do so. That is why the Fed needs to target the dollar/gold price, allowing the market to set all other incidents of variation that come into play when the dollar's value is stable at that particular level. A related problem that arises with respect to his premise that the Fed can bring down the price of gold by using a particular ff rate is the practical consideration of the Fed's thinking about what it must do. The Fed is apparently following conventional wisdom in thinking it must raise rates to achieve a lower gold price. Unfortunately, that path leads to higher inflation, a higher yield curve, an inverted yield curve and sharp recession before finally arriving at a lower gold price. IMO there is no efficient way to arrive at a stable value of the monetary unit while allowing it to float unless that stable value is specifically targeted. W

From: Jude Wanniski
Sent: Monday, October 18, 2004 3:27 PM
To: Scott Grannis

I'm going to think about this latest riposte. I remain open to the possibility that you may be right, but we are in uncharted territory here, unless you can point me to some charts. I'm assuming when you say the Fed has only three options that you mean that is true only in the absence of a commodity price target. No? If they will not target gold, they do have, as you say, three weak options. If they are trying to manage the economy rather than price stability, we are in a monetary quagmire. I think. But let me think some more.

From: Scott Grannis
To: Jude Wanniski Subject: RE: Oil and gold
Date: Mon, 18 Oct 2004 16:02:06

<<Commodities vs Fed.pdf>>



Here's a chart that might help. The real ff rate is to me the best measure of how tight or easy the Fed is. Gold helps quantify this, of course, but I think the real ff rate is an essential ingredient to knowing where the Fed stands. As the chart shows, commodity prices rise after the Fed eases, and they fall after the Fed tightens. When the Fed doesn't tighten enough, commodities just keep going up. "Tight" policy looks to me like it is equivalent to a real ff rate north of 2%. Easy is south of 2%. Once the real ff rate gets high enough, deflationary/disinflationary things start to happen.

And I agree with you that using any target to manage the economy is insanity. Which is one reason the Fed has been screwing things up repeatedly. And it's one reason why we have been able to generate good returns for our clients, because we understand the Fed better than the market does. Did you know that our 1, 3, 5 and 10 year numbers are better than Pimco's? Not many people do.

From: Paul Hoffmeister
To: Jude Wanniski Subject: Scott Grannis - FF Targeting
Date: Tue, 19 Oct 2004 10:06:14

Thank you for letting me know about your conversation with Scott Grannis, especially because I do not recall receiving an email from him. I appreciate his insight and arguments. Your exchange has brought up again some important questions. Firstly, what is the nature of the Fed's monopoly status; and secondly, what does the empirical evidence suggest?

Clearly the Fed has a monopoly on monetary policy in the United States and those countries pegged to the US dollar. Unfortunately, the Fed is using this power to manipulate an ineffective lever, therefore I don't think it's accurate to describe the Fed as a "monopoly producer" that is able to add and subtract liquidity. The Fed is more like a "monopoly interest rate determinant", which has the power to manipulate the yield curve, and in turn, the power to influence the business climate (as do Congress and terrorists, for example, through fiscal policy and economic destruction, respectively). I think the power of the yield curve's effects on economic growth is nicely illustrated in the chart, Post-Bretton Woods Yield Curve v. Nominal GDP Growth.

With the Fed targeting the funds rate for about 15 years now, we're fortunate to have empirical evidence of its effectiveness. The article I wrote emphasizes that ff targeting has not succeeded in stabilizing the gold price, and that other factors have primarily moved gold, such as fiscal events and external shocks. I'm finding this argument to be more coherent than the arguments that "we haven't moved the fed funds fast or far enough". By the way, if the economy is in a deflation, how far can the monetary authority decrease interest rates? Japan is more empirical evidence that history doesn't support ff targeting.

Looking at the recent evidence, I checked the monetary base growth over the last 13 months; note the Fed and the markets generally began pricing in a hike in March '04:

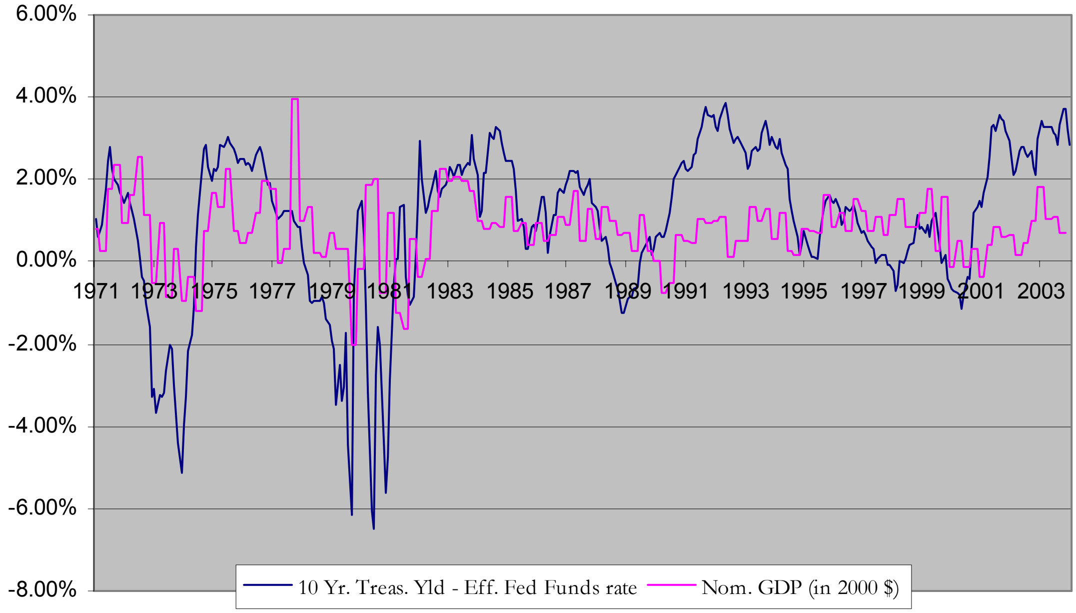
Monetary Base Growth in Millions (Monthly)

Sep. 708982 0.00%
Oct. 712583 0.51%
Nov. 717147 0.64%
Dec. 725201 1.12%
2004-Jan. 725152 -0.01%
Feb. 723942 -0.17%
Mar. 725610 0.23%
Apr. 729913 0.59%
May 733465 0.49%
June 738787 0.73%
July 745960 0.97%
Aug. 746328 0.05%
Sep. 750226 0.52%

Popular theory would suggest that monetary growth should have at least slowed in April, not increased! However, our "treadmill effect" theory explains the increase: if banks expect higher rates in the future, they will bid for more reserves before rates rise, forcing the Fed to monetize debt that adds liquidity to the system. The Fed is forced to add liquidity to reach its credit price target, counter to its intention.

I continue to find these arguments more coherent, and with them, no excuses such as the Fed didn't move rates fast or slow or far or little enough. Jude, of course you know much better than I do. Didn't the monetarists argue something similar when Volcker's M targeting wasn't getting the job done?

Post-Bretton Woods
Yield Curve v. Nominal GDP Growth
(Yield Curve = 10 Yr. Treas. Yield - FF rate)



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