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FYI: A Weak Dollar Scenario

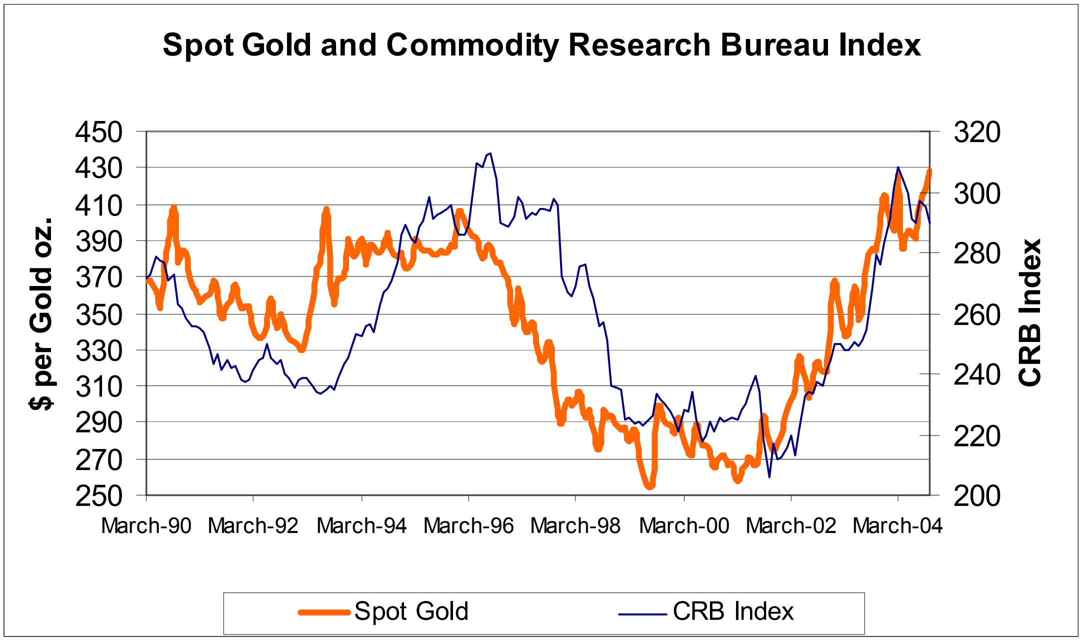
The worst possible news the currency markets could have gotten last week was the report that 337,000 new jobs were created. Equities rallied because the re-election of President Bush was seen in positive terms on tax policies. But even simpletons could see that the jobs number sharply increased the likelihood that Federal Reserve Open Market Committee will continue following its game plan of raising the federal funds rate at a measured pace and perhaps accelerate. If so, this will mean a continued climb in the gold price, which is now $50 higher than it was when the Fed first signaled it might be raising rates. This would mean a further fall in the dollar's value internationally, a rise in long-term interest rates -- and an inflation that can only undermine equity values because capital taxation is not indexed to adjust for inflation.

Edmund Andrews of the *New York Times* this morning reported that while the Fed is almost certain to raise the funds rate by a quarter point to 2% when it meets Wednesday, the startling jobs report last week will not necessarily cause it to bump funds again at December's meeting. He says even at 2%, "'real' short-term rates will still be slightly below zero after subtracting the rate of inflation." This is true only if you do not count the $433 gold price as implying a 20% increase in the general price level as other prices catch up with gold. Andrews also writes that "Historically, the real federal funds rate… has averaged about three percentage points above the inflation rate." This is also true if one begins "history" in 1971 when the dollar was unhinged from its gold anchor. Prior to 1971, the funds rate was almost always *below* the reported inflation rate. In recent weeks we have asked several academic economists who have worked in the monetary field if there is any modern research supporting the idea that the spot prices can be controlled by the funds rate and none can recall anything specific.

Market commentators are still hung up on the idea that the dollar has been declining against the euro and yen because of the trade deficit, but we continue to believe it is because the Fed is flying blind. Greenspan & Co. may be a wise and dependable group, but they have wandered into a blind alley. There is not one man or woman in the Bush administration or on Capitol Hill who realizes the Fed is acting on a *hunch* that raising the funds rate will pre-empt an incipient inflation. The FOMC is acting without any support in modern or classical economic theory on how to prevent inflation. It is simply guessing higher interest rates will produce price stability. If the giant current account deficit is causing the dollar price of gold to climb, weakening its value against the euro and the yen, why is China's current account in rough balance when its currency is pegged to the dollar?

Even fiscal policy effects appear limited in correcting the dollar's inflationary bias. Unlike the 1997 Clinton tax cuts, which appeared to be a significant factor in bringing the gold price lower, improvements to tax policy since 9/11 have failed to reverse the gold price's steady climb. Gold has continued to rise despite the tax reductions on dividends and capital gains put through last year, and the tax extender and FSC legislation which made it through this year. Indeed, even as President Bush -- fresh from an electoral victory that gives him greater majorities in the House and Senate -- laid out plans to reform social security and make significant improvements to the tax code, gold continued to move up reaching $433/oz.

Given the toll on markets from 9/11, Sarbanes-Oxley, high oil, Iraq and the Middle East, and a Fed policy that consistently fails to achieve price stability, the gold price might be even higher were it not for improvements in fiscal policy. Yet, it's possible that even with great tax reforms in the offing, the average gold price may not come lower for some time. As we see in the graph below of the dollar-gold price and the Commodity Research Bureau Index (CRB), a rising dollar-gold price suggests more commodity price rises ahead.



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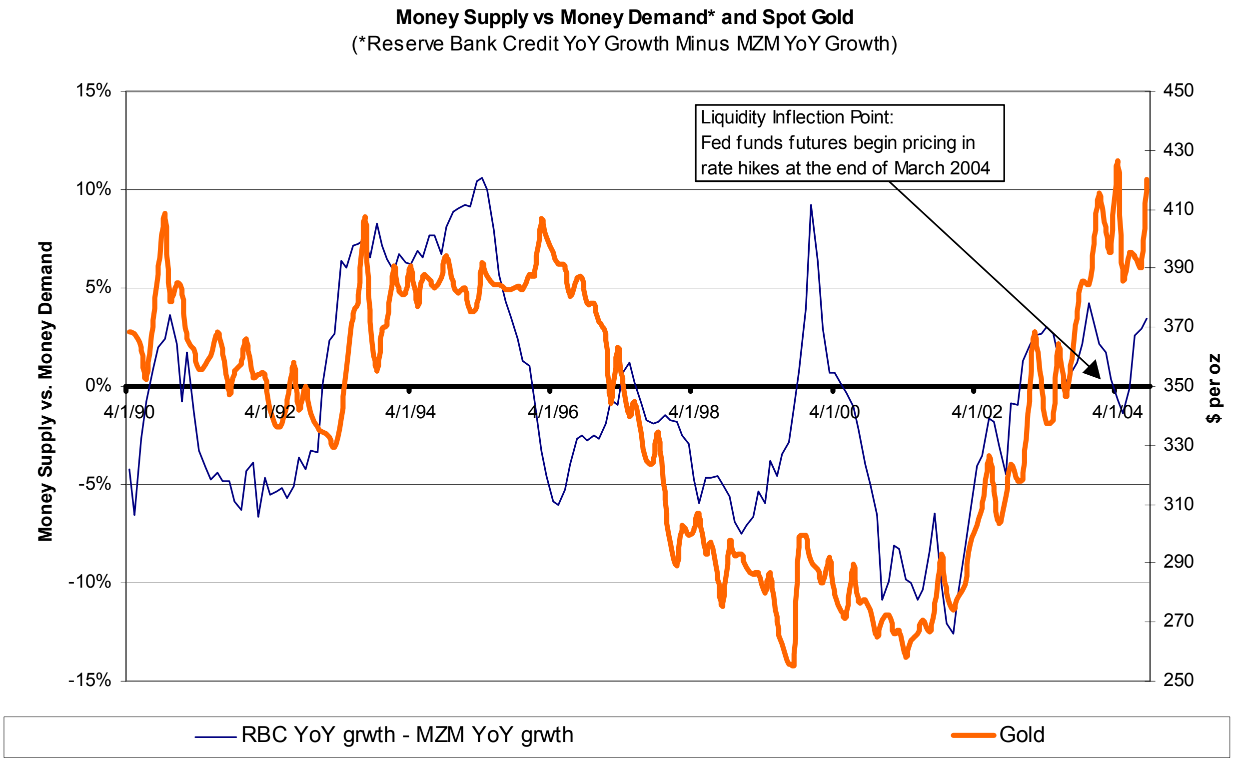
Money Supply is Outpacing Money Demand

The only solid explanation of why the gold price is rising is that the Fed is supplying more reserves to the banking system than are being demanded.



In recent years, the consistent rise in gold has been strongly correlated with the growth in the Fed's balance sheet (i.e., reserve bank credit) relative to MZM (a measure of liquid money not tied up for extended periods of time). Roughly speaking, equivalent growth rates in reserve bank credit (money supply) and MZM (money demand) should lead to general price stability. As depicted above, the year-over-year growth in money supply is currently outpacing money demand, pushing gold higher.

Between November 2003 and April 2004, excess liquidity was beginning to be reined as year-over-year money supply growth slowed relative to growth in money demand, *before* the Fed materially pursued its objective to tighten. In late March, fed funds futures began pricing in future rate hikes. The Fed, by changing its stated objectives and in pursuing a higher funds rate: 1) invited a rush for reserves by banks (that increased money supply), and 2) sapped business confidence of economic actors (thereby reducing money demand). *As a result, Fed policy intended to maintain price stability appears to have worsened a moderate inflation.*

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