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March 28, 2005

OUR CASE AGAINST THE FED

The responses of the markets to last Wednesday's Fed signal of heightened inflation concerns inspired several questions from clients about our analytical framework and our conclusions that the Fed's rate hikes do not strengthen the dollar. This paper is a staff effort that provides market evidentiary validation of our theoretical framework and analysis.

In the financial markets, which price assets over time, the Wednesday reaction was obviously negative, with equities and bonds tumbling in response to sudden expectations that rates will go higher, sooner. Yet the gold market, which prices only the spot intersection of the supply and demand for dollars against the supply and demand for gold, soon showed the dollar rising in value against gold and of course rising against other major currencies. Why didn't gold rise with bond yields, which we know for the most part rise and fall with inflation expectations? Are our critics right in arguing that even faster and bigger increases in the ff rate are needed to defeat the incipient inflation that the Fed now says is breathing down our necks? Before presenting our evidence, we will first respond to the issues raised about our theoretical analysis.

In his Wednesday brief for us, Paul Hoffmeister pointed out that the gold price has lagged moves in the bond market: "Though the decline in spot gold is a positive signal of reduced excess liquidity today, we expect gold and other inflation signals to resume their upward climb as the slowing economy in the near-term responds by demanding fewer dollars. This has been the pattern since 2003 where information suggesting higher interest rates, such as falling eurodollar futures, leads to temporary dollar strength but is usually followed in a matter of weeks by a reversal, as real economic actors demand less dollar liquidity."

At the micro level, our West Coast representative Wayne Jett brought up the treadmill effect in another explanation of the lag:

My belief is that the rate hike provokes an immediate increase in the demand for dollars in the real estate mortgage markets. This causes the prompt (same day) drop in the POG. Then this drop gives way to a rise in the POG as bank lenders are called on for loan commitments to nail down capital costs before future rate increases; these bank lenders must go to the Fed to increase their reserves with overnight funds, which has the effect of actually increasing liquidity flows from the Fed into the market. Demands for the dollar recede in anticipation of a slowing economy caused by increased costs of capital that are seen as leading eventually to recession. The increased liquidity flow from the Fed,

combined with reduced demand for dollars over a term of days, produces more excess liquidity and thus a rise in the price of gold (fall in dollar value).

I'm also puzzled by the assertion of some observers that the Fed's increase in the ff rate target requires a reduction in the liquidity flow of dollars. Precisely how does that "tightening" of liquidity occur? So far as I can tell, the Fed's action does nothing other than increase the cost of funds. The Fed does not decrease the volume of funds flowing; the Fed only relies on the theory that an increased price for its funds will reduce demand and lower the flow of funds. Again, there is no proportional relationship between the ff rate and the dollar's value, so the case that the Fed's action makes the dollar stronger just does not hold together.

Indeed, most of the people in favor of raising short-term interest rates want to do so in order to slow the growth in money supply. This idea completely ignores money demand, the other half of the monetary equation. Even if higher short-term rates slow money supply growth, gold would not decline if the reduction in money supply corresponded with a proportional decline in money demand. The Fed cannot hit more than one target, in this case both the supply and demand for liquidity, with one instrument. However, the Fed can manage both of these variables by targeting the gold price.

Yet another criticism we have heard is that our framework does not take into account the increased attractiveness of dollar bonds when the interest rate increases. A related argument is that the yield on long-term bonds is not **wholly determined by future inflation**. We believe neither point has merit.

On the last point first, it should be clear that the Fed cannot make long-term rates go up by raising the overnight rate. This is what Greenspan's "conundrum" is all about; he had to admit he did not know why the yield on the 10-year note was falling while the overnight was rising. The only explanation that makes sense is that for a period, the demand for money was outpacing supply, as evidenced by the decline in the gold price. We should point out once again that gold is the **ONLY** commodity that does not backwardize; its future price is always its spot price plus the interest rate over the maturity of the government bond. Greenspan knows this (although most Fed policymakers do not), which is why we were puzzled when Greenspan in recent testimony cited the long-term bond yield as a true inflation indicator. If true, why would he be trying to get the yield to **RISE** as evidence that the Fed is wisely making the effort in a measured way in order to prevent a new round of inflation?

On the other point, which is a most conventional one that neo-Keynesians have been peddling for years: Higher yields on government dollar bonds do not increase their attractiveness to foreign investors. That's because those yields only rise when the dollar is signaling a higher inflation rate over the life of the bond. Last week, we confronted one assertion that the "real" funds rate is 2% higher than the nominal rate of 2.75%, which would mean the nominal rate have to go to 4.75% before the Fed was truly "tight." We don't think so. There are distinctions between "real" and "nominal" rates when there is a time element involved, but there is virtually no time element in the "overnight" funds rate. It is the only rate where the real and nominal values are identical. Even in a hyperinflation, you would not charge interest on a \$100 loan if the borrower would make change and pay you back with five \$20 bills within the hour.

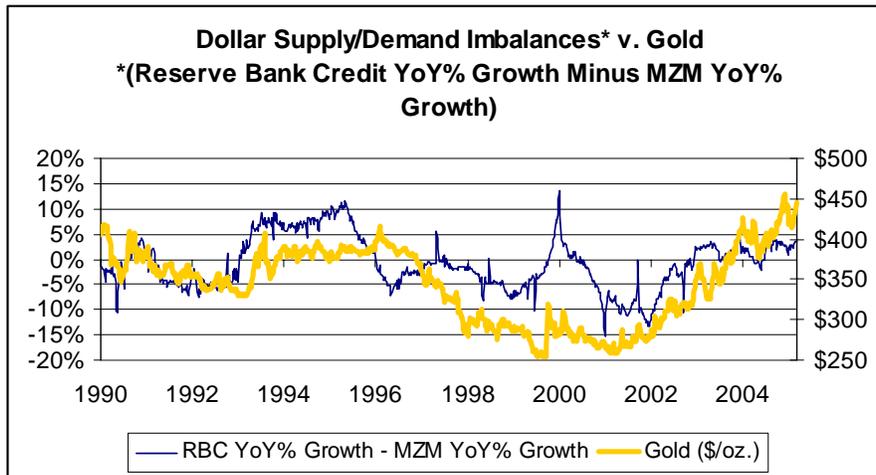
The idea that higher interest rates are more attractive than lower rates seems eminently logical, which is why the notion occupies so much space in the financial pages. But, if we consider Japanese interest rates, we must wonder why the yen has steadily strengthened against the dollar since we left gold in 1971 – from 360 per dollar to 105 per dollar – when for almost the entire length of that time yields on Japanese governments have been below U.S. governments. The answer lies in checking the yen/gold price, which for that long period has consistently held its value far better than the dollar's.

For those too young to remember, in 1972 and early 1973, Switzerland was still trying to maintain the gold weight of the franc while the rest of the world floated following the collapse of Bretton Woods. It had the lowest interest-rate structure in the world; even Japan let the yen/gold price rise. Contrary to “logic,” the higher price for the Swiss franc made it the most sought-after currency on the planet. Why? Because a gold franc would eliminate any possibility of inflation OR deflation in contracts with a time element. As I recall, the “money supply” in Switzerland grew at a 30% annual rate in that period, which led at least one young Wall Street monetarist at the time to predict a coming inflation in Switzerland!! In fact, the SFr/gold link meant the demand for francs and the supply of francs were exactly equal, day-in and day-out.

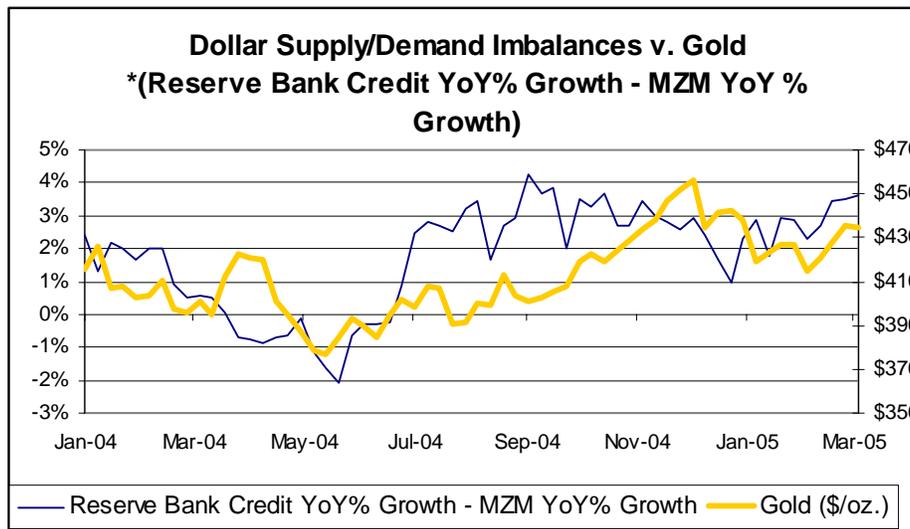
The demand for francs was not internal, but external. Foreigners making contracts across currency lines did not have to buy insurance (hedge their currency bet) to make sure they did not lose assets over the contract period. As I explained at the time, Belgians and Brazilians making contracts to trade butter for coffee could both save the costs of hedging by making the contract in Swiss francs. That period ended when Swiss companies manufacturing for export could not compete with a superhard currency and persuaded the Bank of Switzerland to give up the gold peg so they could survive.

To support our conclusion that higher interest rates are, in fact, not restraining the excessive liquidity dynamic currently taking place, we present evidence of market conditions in three steps:

- 1) Finding perfect proxies for money supply and money demand is close to impossible, we think. Yet reserve bank credit “RBC” and money of zero maturity “MZM” are very useful near-proxies for money supply and demand, respectively. This conclusion is warranted chiefly by their correlation with gold over the last 15 years and particularly since January 2003.



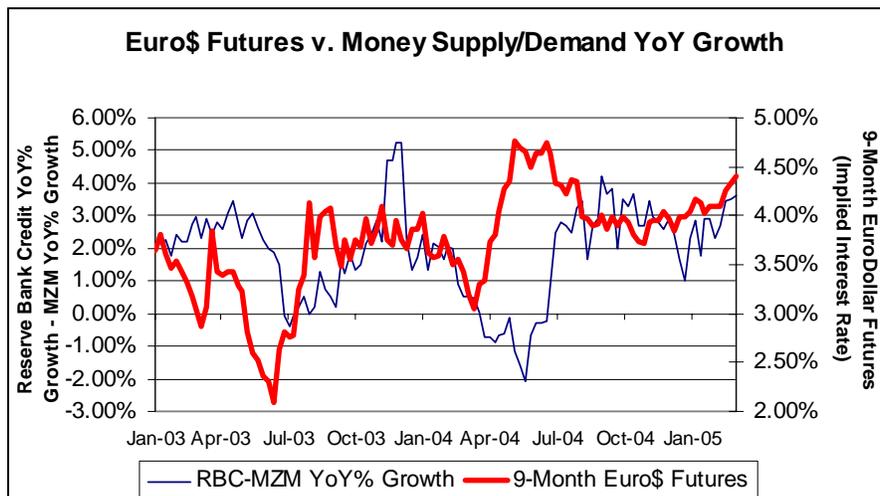
Note: If reserve bank credit YoY% growth minus MZM YoY% growth is positive, it indicates that money supply is outpacing money demand, as has been the case since 2001. If the variable is negative, money demand exceeds supply, as was the case between 1996 and 2001. Around 1994 and 1995, RBC minus MZM growth was constant, corresponding with a stable gold price.



In early 2004, excessive money supply was shrinking relative to demand, until the Fed began "tightening".

2) Establishing that the difference in year-over-year growth rates between RBC and MZM correlate exceedingly well with gold, we can use this data to see the effects that monetary and fiscal policies have on this money supply/money demand relationship and the inflation outlook.

It is our contention, of course, that raising interest rates will not effectively correct the over-supply of dollars relative to demand within the system. Our conclusion is supported very well by the behavior of the RBC/MZM dynamic and the interest rate outlook (depicted by eurodollar futures) over the course of the last two years.



Expectations of increased rate hikes exacerbate divergences in the RBC/MZM relationship; they do not restrain inflationary pressures.

We think this graph offers excellent evidence that the hawkish interest rate expectations have a **detrimental** effect on the money supply/demand dynamic, i.e., higher rates cause excessive monetary liquidity by virtue of their unfavorable effects on money supply and demand variables. This graph illustrates that as long-term interest rate futures decline, so does the excessive liquidity dynamic indicated by the RBC/MZM variable, and vice versa. As you can see in the graph, in the summer of 2003, the dovish interest rate outlook corresponded with a favorable decline in the difference between RBC and MZM growth rates (the gap between money supply and money demand was narrowing). However, as the interest rate outlook in the spring of 2004 became more hawkish, the decline in excess liquidity reversed, which of course corresponded with a rise in gold.

3) Examination of the relationship between eurodollar futures and the RBC/MZM variable should make the case that higher rate expectations are increasing inflationary pressures. But there is more good evidence that supports this argument. The following is a graph illustrating the behavior in eurodollar futures, gold, oil and ten-year Treasuries over the last seven weeks.



As you can see, on the same day (February 9) that eurodollar futures declined in value (i.e., as they began pricing in increased rate hikes by the end of the year), gold, oil and long-term bond yields bottomed.

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We repeat our conviction that world commerce will remain inefficient and substandard without a new gold-based Bretton Woods arrangement. Everyone in the world who does business by contract has to bear the risks of currency change that the Belgians and Brazilians did in our example; Americans who do business with each other bear the risks of inflation and deflation in

the dollar. The arguments in this paper, though, are more directly aimed at demonstrating the weakness of the Federal Reserve's current policy. The policy has been an experiment throughout with no theoretical underpinnings, one that ignores the Mundellian warning that the Fed cannot hit two targets with one instrument. Alan Greenspan will of course say that Congress has given the Fed this instruction – managing the unemployment rate as well as the inflation rate. And of course he is correct. The only way to eliminate inflation while optimizing unemployment is with a stable dollar, which requires targeting the dollar's value. It is the constitutional responsibility of the Congress to manage the national money, a responsibility it has delegated to the Federal Reserve and may have to retrieve in some way if the Fed's counter-productive experiment gets out of hand.

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