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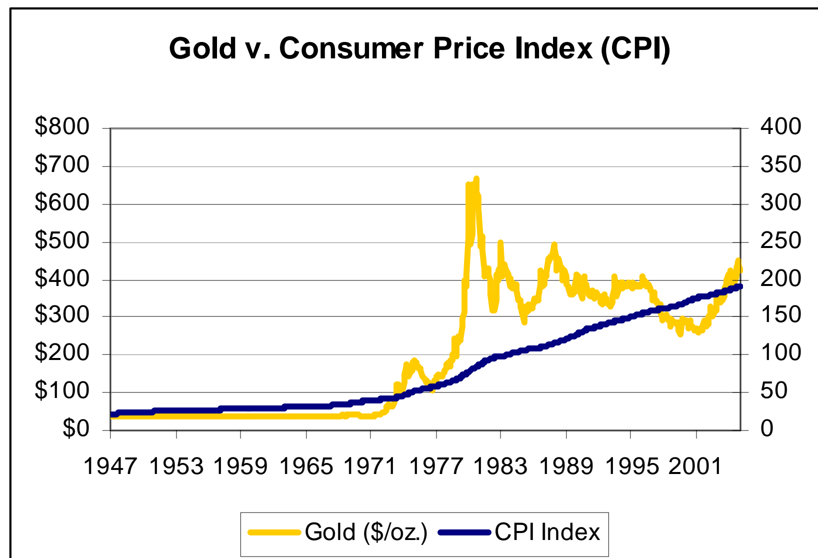
# GREENSPAN'S 'CONUNDRUM' EXPLAINED

In his congressional testimony two weeks ago, Fed Chairman Alan Greenspan said without prompting that he didn't understand why the Fed's increases in the federal funds rate since last June 30 were not accompanied by increases in interest rates across the board. Indeed, for a period last fall, long-term bond yields were lower than they were when the Fed began the rate hikes. Here's how he put it: "it is difficult to attribute the long-term interest rate declines of the last nine months to glacially increasing globalization. For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum. Bond price movements may be a short-term aberration, but it will be some time before we are able to better judge the forces underlying recent experience."

In one sense it was nice to see Greenspan admit ignorance about the behavior of the money markets, a realm over which he presides, but it simply adds a conundrum to the enigma he had previously acknowledged in his quest for a funds rate that would balance inflation and employment goals. He's saying he really doesn't know what's going on, confirming my view of June 30 last year when the Fed began the quest with a quarter-point rise in the ff rate. I'd written in a client letter that morning: "My concern is that at no time in our history has the monetary authority faced this set of circumstances and in a sense it is flying blind."

We've literally been alone in the universe this past nine months in arguing that the funds rate should have stayed at 1% because there was no inflation in the system – and increases in the funds rate would if anything create a new inflation. The earlier inflation, which began when we left gold in 1971, had been completely defeated by the deflation of 1997-2001. Other supply-siders – along with Keynesians at the *Washington Post* and *New York Times* – argued the opposite, that Greenspan was being timid with his measured pace and should be raising the overnight right by at least half points or even full points to get it to 5% where it belonged. My good friend George Gilder wrote on his website that "Jude is losing it." Before I go further, take a look at the following chart, which plots the gold price against the Consumer Price Index going back to 1947.

What the chart should tell you is that by June 30 the CPI had finally caught up to gold, which meant the bond market was doing its job of taking an inflation premium out of the length of the yield curve. The higher funds rates that followed were doing nothing to squelch an incipient inflation, only slowing economic growth and the demand for liquidity, thereby causing the gold price to rise. A gold price of $435 implies a modest increase in the CPI over several years before it again catches up with gold at that level. This is why the long end declined last fall even as the ff rate inched up, when gold fell to $410 when news on other economic fronts increased the demand for dollar liquidity. This explains the "conundrum." Bear Stearns, which has been pushing for a 5% rate, put forward the sappy idea that the long end was stronger than it should be because the surplus liquidity in the system had no place to go, so it was gobbling up government bonds. That stands Milton Friedman's quantity theory on its head.




I sent the chart to several Fed officials and one replied: "My concern about the CPI - gold link seen in your chart is that, even though there is clearly a long-term relationship, there are also wide short-term deviations as in the 1980s. So how can gold give us a reliable signal in the short run, e.g., right now when the gold price is only modestly above the CPI trend? What am I missing?" Here is part of my response:

> The reason there are "short-term deviations" in the 1980s is that the gold price is by far the best leading indicator of "monetary inflation," but the lead takes a long time to unfold in an economy where the maturity of the debt structure is quite long. If the average maturity of the debt structure, public and private, is 10 years, and the price of gold doubles next week, it takes 10 years for the CPI to catch up. Of course it doesn't take nearly that long for the bond market to price in the decline in the purchasing power over the near term. You can understand this best if you think of a hyperinflation, where the maturity of the public and private debt structure is measured in days, even hours. When the price of gold doubles in pesos or reals, the prices of goods and services doubles in days. This was the Brazil experience and the Argentine experience and, of course, the experience of Germany in the early 20s.
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> Your question, about how the gold price can give us a reliable signal in the short term, when it is only modestly above the CPI trend, is a good one. The answer is that you don't need any more proof than the fact that as you have been raising the ff rate, the market has refused to shift up the yield curve. The market only

> sees a modest increase in prices in the short term and will not discount long-term price increases until they see the whites of their eyes. That is, the 10% increase in the gold price since 6/30/04 does not translate into a 10% increase in the 10-year yield because the market can't see what our government is going to do, what you are going to do, at the next FOMC meeting, let alone 10 years out, so it does not discount the unknowable.

We may be making a little progress in our own quest to get the Greenspan Fed to abandon its search for the perfect funds rate and switch to gold. I'm hoping the chart will do for monetary policy what Laffer's Curve did for fiscal policy and we are e-mailing it to all the FOMC members, hoping they will give it a gander. If nothing else, it reminds us that before we left the Bretton Woods arrangement with gold, the statistical inflation was trivial and the dollar did its job so well in guiding capital allocation that there were never any energy shortages.

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