Keep The Fed Away From The Dollar

Seldom are economists at a loss for comic diversion. Sometimes the yuks are served up from inquiring media, but more often the knee-slappers come from fellow practitioners, both real and self-proclaimed, of the Dismal Science. As the late George Meany, longtime head of the AFL-CIO, famously observed economics is the only profession where a person could have a lifelong reputation as an expert without ever once being right.

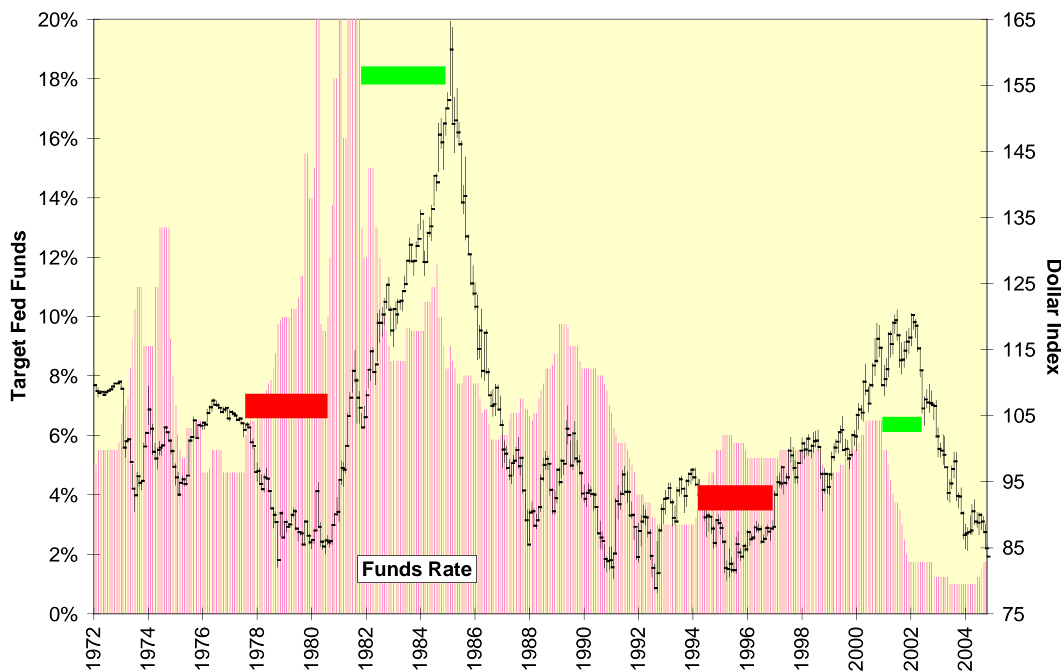
Take the Federal Reserve, please. It was only two months ago that certain commentators were insisting that the campaign to raise the federal funds rate should be held in abeyance to offset the then-rampaging price of crude oil. Now the full-throated set is insisting the central bank raise interest rates even faster to defend the value of the dollar.

Cease and desist, folks: Monetary policy is an extraordinarily blunt instrument, one whose effects are not known in advance by anyone, the Federal Reserve included. No one can tell you beforehand what the effects of the latest set of customer repos, matched sales, coupon passes or federal fund rates changes will be. Nor can anyone provide you with a timetable of when these changes will manifest themselves.

Each economic situation is different, and by the time monetary policy changes rattle through the system their effects can be overwhelmed by any number of fiscal developments, external shocks, and most importantly by both the exchange value of the dollar and the yield curve.

The Federal Reserve's mission, which it often diverges from, is to provide sufficient liquidity for non-inflationary growth. It is not to offset the price of crude oil or the latest trend in stocks, nor is it to engage in currency manipulation. Besides, even if the Federal Reserve were to target the dollar, it would be a long time before anyone noticed its success. The chart below depicts the history of federal funds rate targets back to 1972 against the dollar index. The red blocks mark the time between rate increases and subsequent dollar rallies, the green blocks between rate cuts and subsequent dollar declines. No short-fused day-traders need apply for this task.

Does The Fed Target The Dollar?

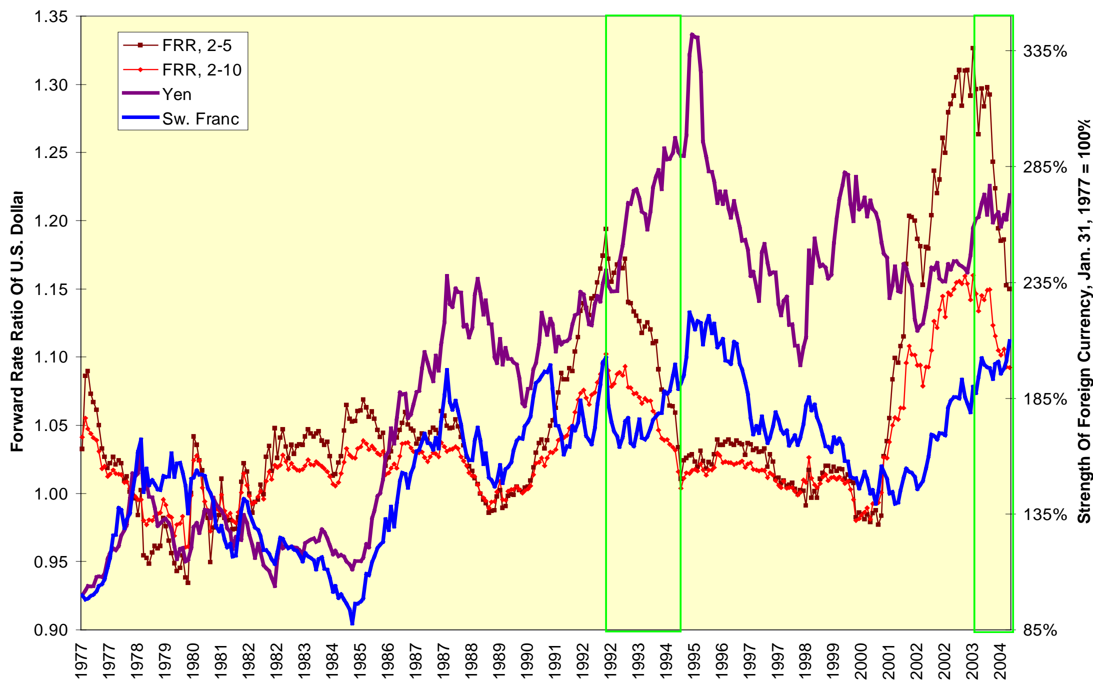


One Curve Good, Two Curves Better

The second reason why the Federal Reserve should not diverge from its present course is the mechanics of currency markets. All such transactions involve borrowing the currency to be shorted, exchanging the currency at the prevailing spot rate, and then lending in the currency to be bought. No underlying physical trade flows are required

to support these transactions. And no capital outflows are required, either: The dollar has been getting whacked at a time of massive capital *inflows*, chiefly from Asian central banks, and U.S. stocks have been putting on a pretty good show to the upside as well.

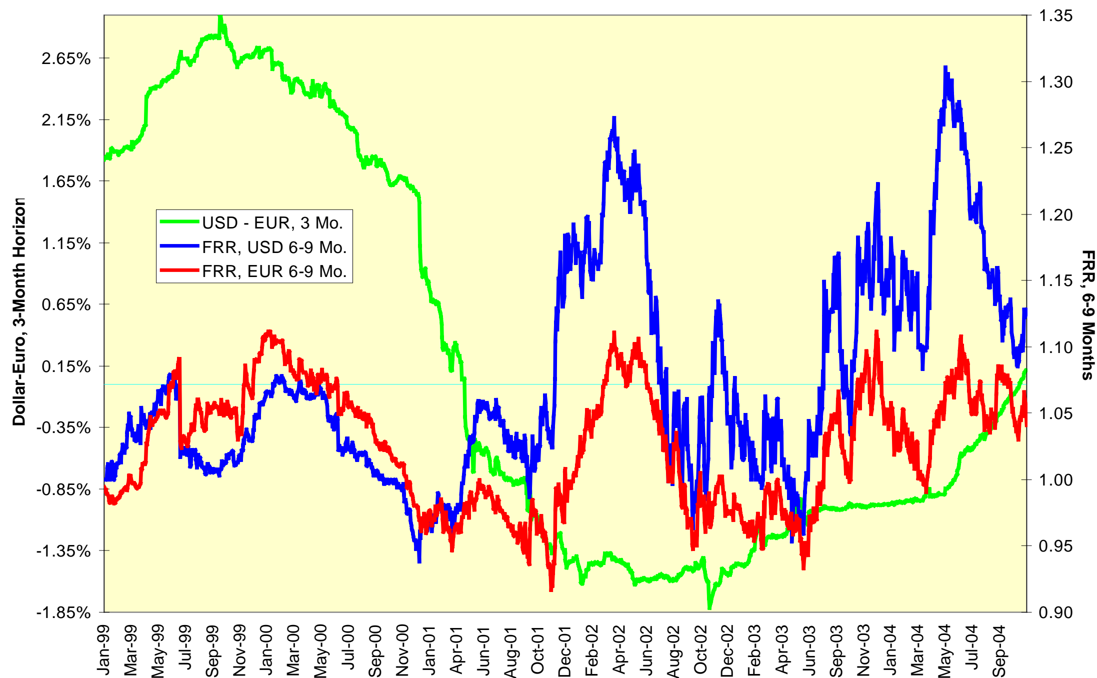
It would do the Federal Reserve no good whatsoever to accelerate its tightening of credit if the actions were not coordinated with other central banks. The U.S. note curves, as measured by the forward rate ratios between two-years and both five and ten years, have been flattening sharply since the spring of 2004. The forward rate ratio is the rate at which you can lock in borrowing between two maturities, divided by the yield at the longer of the two maturities. A similar flattening took place between late 1992 and the end of 1994, highlighted by the first rectangle in the chart below. That earlier flattening witnessed a run against the dollar, especially by the Japanese yen. The present flattening is accompanied by similar dollar weakness.



Some should recall that the previous period of dollar weakness did not precede the end of the world, a fact you can confirm for yourself by virtue of reading this today. No, once the note curve stopped flattening and the dollar stabilized the great bull market of the late 1990s commenced. A good time was had by all.

The borrowing/lending relationship noted above means that currency trades are driven by interest rate differentials, and not simply at a single maturity but rather across the money market curve. It is not enough to take simple interest rate differentials at, say, the three-month horizon; we must look at what the money market's forward curve for implied reinvestment at the end of that three-month period will look like.

Here the picture is encouraging for dollar strength in the near future. Not only has the nominal rate differential swung back in favor of the dollar, the forward rate ratio of the greenback compared to the euro has been on a narrowing trend. This means U.S. monetary policy has been tightening relative to that of Europe since mid-May.



Threading The Needle

The Bank of England is on Threadneedle Street in London, and that describes the Federal Reserve's task. If they bend to the wind and accelerate the rate hike campaign, they risk a potentially catastrophic policy error that could derail the U.S. economic recovery via bond market de-leveraging. If they abandon the rate increases on the first piece of weak economic data, they risk an acceleration of inflation. Their best course, one that they appear to be on, is to ignore the current weakness in the dollar and keep on adding 25 basis points at every meeting. The market can understand this and accommodate it well.

The same conclusion will be reached next week when we examine the role of carry in the fixed income market and how the measured pace of rate increases is optimal for unwinding the excesses of the past three years.