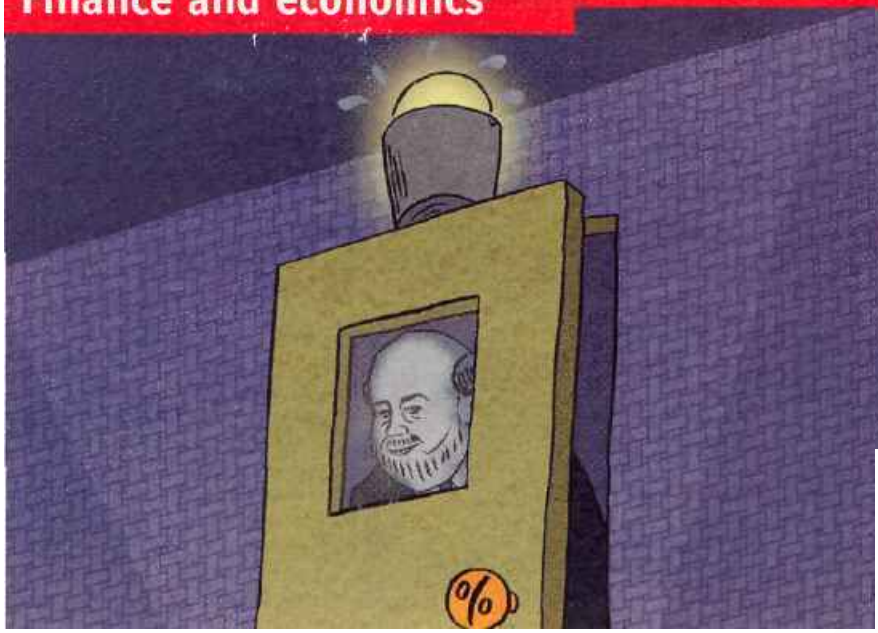

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Global monetary policy

Ben's bind

WASHINGTON, DC

Disentangling the links between the Fed, the falling dollar and the soaring price of the world's commodities

THE spirit of St Augustine hovered over the Federal Reserve this week. "Oh Lord, let us stop cutting interest rates, but not yet," is pretty much what America's central bankers decided on April 30th. The Fed's governors cut their policy rate by another quarter-point, to 2%. But the accompanying statement gave a small hint that they may now pause.

There are plenty of reasons to stop cutting. Real interest rates are now firmly negative. Although the housing market continues to contract-the latest figures show sales falling, prices tumbling and the number of vacant homes soaring—the economy is limping rather than slumping. According to initial GDP estimates released on April 30th, output grew at an annualised rate of 0.6% in the first three months of the year-the same pace as in the previous quarter and faster than most people expected. The mix of growth was not good. Final sales fell while firms built up their stocks, which bodes ill for future output. But with tax-rebate cheques arriving in the mail, a dose of fiscal stimulus is imminent.

A growing chorus worries that ever lower policy rates are adding to America's problems. Some prominent economists, inincludingMartinFeldsteinofHarvardUniversity and Bill Gross of PIMCO, a big money-management firm, have urged the central bank to stop. Fed cuts, they argue, are doing little to reduce borrowing costs but have sent commodity prices soaring-fuelling inflation and hitting Americans' wallets hard.

Thanks to the credit crunch, Fed loosening plainly packs less punch than hitherto. Lending standards are tightening across the board. The cost of a 30-year mortgage has risen over the past six months, even as short-term rates have tumbled. But monetary policy has not been impotent. One route through which it has worked has been the weaker dollar. Although the greenback has been sliding for over five years, the pace of decline stepped up as the Fed slashed rates. Since August the dollar has fallen by 7% against a broad basket of currencies and 13% against the euro. Together with strong global growth, this weakness has cushioned and reoriented America's economy. Strong foreign earnings have boosted corporate profits. Strong exports have countered the weakness in construction. Exclude oil, and America's current-account deficit has shrunk to an eight-year low of 2.4% of GDP.

But oil-and other commodities-are the crux of the problem. In the past, economic weakness in America has usually pushed the price of oil and other commodities down. That relationship has weakened thanks to demand growth in big commodity-intensive emerging economies. But the recent surprise is that commodity prices have soared even as America's economy has stalled and forecasts for global growth have been trimmed as well. No one expects global growth to accelerate this year, yet the price of crude oil is up 20% since the beginning of the year, The Economist's overall commodity-price index is up 18%, the metals index is up 24%, and the food-price index is up 18%. Supply shocks-from drought in Australia to strikes at Nigerian oil wells—are clearly part of the problem. But the fact that prices have soared across so many commodities suggests a common cause.

Could the culprit be the Fed? Advocates of this idea point to two channels. First, by slashing real interest rates, the Fed has encouraged speculation in commodities by reducing the cost of holding inventories. Second, by pushing down the dollar, Fed looseness is pushing up the price of dollar-denominated commodities.

Jeff Frankel, a Harvard economist, has long argued that low real interest rates lead to higher commodity prices. When real rates fall, he points out, commodity producers have more incentive to keep their asset-whether crude oil, gold or grain-in the ground or in a silo, than to sell today. Speculators, in turn, have more incentive to shift into commodities. There is no

> doubt that commodities have become an increasingly popular investment category-in fact they bear many of the hallmarks of a speculative bubble. But inventories for many commodities, particularly grains, are unusually low.

What about the dollar link? Chakib Khelil, president of the Organisation of Petroleum-Exporting Countries, argued this week that oil could reach $200 a barrel largely because the market was being driven by the dollar's slide. Movements in the euro/dollar exchange rate and the price of oil have become extremely close (see chart on previous page). An analysis by Jens Nordvig and Jeffrey Currie of Goldman Sachs shows that the correlation between weekly changes in the oil price and the euro/dollar exchange rate has risen from 1% between 1999 and 2004 to 52% in the past six months.

That link is partly a matter of accounting. If the dollar falls, the dollar price of a commodity must rise for its overall price-in terms of a basket of global currencies-to remain stable. But commodity prices have risen even when priced in non-dollar currencies. And the correlation between changes in the price of oil and the euro/dollar exchange rate has risen even when oil is priced in a basket of currencies, such as the IMF'S special drawing rights.

So is the weaker dollar driving oil prices up or are high oil prices driving the dollar down? The Goldman analysts argue the latter. Dearer oil is pushing the dollar down, they claim, because oil exporters import more from Europe than America and hold less of their oil revenues in dollars. A second factor lies with central banks. Because the Fed focuses on "core" inflation (which excludes food and fuel), whereas the ECB targets overall inflation, America's central bank runs a looser policy in response to higher oil prices, thus pushing the dollar down.

Another reason to suspect that the Fed is more than a bit player is that American interest-rate decisions have a disproportionate effect on global monetary conditions. Some emerging economies still peg their currencies to the dollar; many others have been reluctant to let their exchange rates rise enough to make up for the dollar's decline. As a result, monetary conditions in many emerging markets remain too loose. This fuels domestic demand, pushing up pressure on prices, particularly of commodities. All of which suggests that the Fed's decisions are propagated widely through the dollar.

The most recent circumstantial evidence also suggests that the Fed may bear some responsibility for the commodities boom. The dollar slipped after the Fed's rate-cut decision as investors reacted to its doveish tone, though at $1.56 per euro, it was still up 2.6% from its low of $1.60 on April 22nd. The price of oil, after hitting a record high of almost $120 a barrel on April 28th, had tumbled to $113 on April 30th. But the price of crude and other commodities rose afterwards. If those reactions persist, America's central bankers may have to reflect carefully. •

Bank of Japan

In a pickle

TOKYO

A monetary-policy conundrum familiar elsewhere, new to Japan

EVER since the deflationary era, the Bank of Japan (BOJ) has longed for the day when monetary policy could once again mirror that of the more "normal" economies in the rest of the developed world. Now Japan's central bankers are learning to be careful what they wish for. They are beginning to experience exactly the same dilemma faced by their counterparts in America and Europe: how to set monetary policy when threatened with an American-led downturn on the one hand, and rises in the prices of commodities and food on the other.

The dilemma sharpened in late April when inflation figures were published. In March Japanese consumer prices (including energy and food) rose by 1.2% compared with a year earlier, the highest pace in a decade. The bulk of the rise came from energy, but food also loomed large. Spaghetti, which the Japanese love to eat with seaweed and cod's roe, has risen by over a quarter in the past year, and at the end of April hoarders cleared the nation's supermarket shelves of butter. With surveys showing that more than 80% of households feel inflation is rising, it is hard to argue that Japan any longer holds a deflationary mindset. Even "core" inflation (that is, not counting energy or food) grew by 0.1%, the first increase since 1998.

Anyone seen the butter?

At the same time, the central bank is concerned about growth. The BOJ consensus seems to be that the worst of America's financial turmoil is now over, but that uncertainty now hangs over its real economy, with risks for Japan. Export volumes to the United States are falling, while the growth in exports to Asia and Europe is slowing. A stronger yen is beginning to squeeze company profits. In March, industrial production fell unexpectedly.

A troubled picture, then, for the BOJ. When policymakers met on April 30th for the first time since a new governor, Masaaki Shirakawa, was appointed, it cut its growth projections for the year starting in April, to 1.5%, while keeping interest rates on hold, at 0.5%. It also shifted its policy stance. Whereas before it was expecting to raise rates in future, the central bank now appears to have a neutral bias—that means it is as ready to cut as to raise them. For an institution so famously hawkish on inflation, that is an indication of how murky the outlook has become.

Fonte: The Economist, n. 8578, p. 80-81, 3 May. 2008.