The Dismal Science: Mr. Greenspan's Strategic Reserve
Susan Lee. *Wall Street Journal*. (Eastern edition). New York, N.Y.: Sep 20, 2004. pg. A.21

There is little doubt that the Federal Reserve is about to pump up the federal-funds rate by 25 basis points to 1.75% as part of Alan Greenspan's kabuki dance to control inflation. It is also a textbook response to oil prices that are now about 35% more expensive than they were at the beginning of the year. But the truly deft and sneaky aspect of the increase is that higher oil prices themselves are probably a result of Mr. Greenspan's really loose monetary policy.

This explanation of the current situation is in fact a mirror image of the one identified by Jeffrey A. Frankel, economist at Harvard's Kennedy School of Government, in the 1980s. ("Expectations and Commodity Price Dynamics: The Overshooting Model," available online.) Back then, real interest rates were high and prices for commodities, including oil, were in a swoon.

Mr. Frankel's argument was simple and elegant. Changes in the money supply resulted in changes in real interest rates and the first impact of these changes was seen in prices for commodities. Thus, as real rates went up, commodity prices went down. Consider, then, Mr. Frankel's model applied to what has been happening more recently.

As Mr. Greenspan engineered low real interest rates in 2001-04, the prices of commodities, particularly oil and other minerals, started to climb in advance of a general price increase. Why? The prices of some things, like manufactured goods, are sticky. They don't change very fast because they may be fixed by explicit contracts, there may be imperfect information, or businesspeople may want to postpone the costs attached to changing their prices. Commodity prices, on the other hand, are way more flexible. Since commodity prices are determined by trading on fast-moving auction markets, they respond more swiftly to interest-rate expectations and monetary fluctuations than do consumer prices.

But, in the short run, these faster-adjusting markets overshoot their long-run equilibrium prices. Since some prices are sticky -- or lag behind -- the prices that are free to move, like commodity prices, must move in an exaggerated fashion in order to compensate for the laggards. Thus, commodity prices overshoot their new equilibrium in order to generate an expectation of future depreciation that is sufficient to offset lower interest rates. This skyrocket effect will vanish in the long run.

So Mr. Greenspan's loose monetary policy created low nominal interest rates and an increase in the expected economy-wide inflation rate. Both caused investors to shift out of money and other financial investments into more attractive assets like commodities. In other words, the expectation that prices will increase, and thus that the value of money will fall, causes investors to shift out of money today; at the same time, the demand for -- and therefore the prices of -- alternative assets, like commodities, increases today. Mr. Frankel says: "As a consequence of the increased demand for commodities, expected future inflation has a positive effect on commodity prices in the present."

And the fact that commodity prices overshoot their long-run value is necessary for a rational market anticipation of future depreciation to balance the lower, real interest rate.

Of course, as Mr. Frankel points out, there are other obvious and specific things active in the oil market. On the demand side, world appetite for oil, fueled by China and India, has been gangbusters. (Also important at the margin has been the U.S. policy to fill the Strategic Petroleum Reserve.) As a result, recent global demand for oil has been growing at over 3% as opposed to its average of a touch under 2% over the past decade. And on the supply side, there have been anxieties about the steadiness of production coming from Russia, Venezuela, Nigeria and Iraq.

None of these things is under Mr. Greenspan's control, to be sure, but his ultra-low interest-rate policy did prompt a burst of speculation in the form of the carry trade. Investors, mostly hedge funds, borrowed U.S. dollars to buy higher-yielding oil. Ultra-low interest rates also made it cheaper for speculators to float giant tankers in the middle of the ocean, waiting until prices reached a peak. (Low rates drive this kind of inventory holding in two ways. If the cost of storage is relatively cheap it makes sense to leave the oil in tankers, hoping the price will go up. Similarly, lower interest rates lower the opportunity costs of making other investments.)

The delicious irony of course is that while Mr. Greenspan blames high oil prices for the recent "soft patch" in the economy, he is, in fact, blaming himself.

But after lowering interest rates 13 times, starting in 2001, the Fed began to tighten in June, twice raising the federal-funds rate by 25 basis points. As a tighter monetary policy raises nominal interest rates above the expected rate of inflation, oil prices will fall as speculators cut inventories, producers pump oil faster, and investors shift out of oil into financial instruments.

Even though real interest rates are negative, the expectation of higher rates has already caused oil prices to fall. Speculators started bailing out of oil in August, selling those floating, off- shore cargoes. Likewise, hedge funds have been unwinding their carry trade positions. And, thus, oil prices have declined since hitting a high of almost $50 a barrel in August.

Of course nobody can predict with daily accuracy what will happen to oil prices if the Fed nudges up the federal-funds rate tomorrow. Even with some of the speculative premium gone, there is still a big, fat risk premium in the market. But one thing is for sure -- it will be a tiny step toward undoing the spike that Mr. Greenspan has nurtured.

Ms. Lee is a member of the Journal's editorial board.