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Greenspan Warning: continue to face significant risks in the near term

Speaking in San Francisco, Federal Reserve Chairman Greenspan shook the money market out of its recent complacency that seemed to suggest no more rate cuts by citing the risks to the recovery sequence now in train. Admitting that the signals from the economy "…**have turned from unremittingly negative through the late fall of last year to a far more mixed set of signals recently**…" he emphasized that the economy faced **"significant risks in the near term."**

Two recent developments may have triggered this forceful re-focusing on whether the Fed should indeed ease again at its January 30th FOMC meeting. First, there has been some 'Fedspeak' from various Federal Reserve Bank Presidents that suggest recovery is proceeding much as expected from the vigorous policy response of the Fed to date. Second, he may be concerned that the failure of the end-of-the-year Bush tax and spending plan will create negative expectations for both the business and household sector. The signs of recovery are admittedly tentative. It is exceedingly hard to disentangle the end of the year efforts of manufacturers and retailers to rapidly clear inventories from true stabilization of the economy. There are three D's leading up to his Decision (and clearly, it will be his call): **Data, Doubts and Determination**.

DATA: In the next 16 days leading up to the FOMC meeting, there will be a plethora of data and as we know, this is a data-driven Chairman. Tomorrow, we have Advance Retail sales followed by the CPI on the 16th and Business Inventories. On the same day, the Industrial Production and Capacity Utilization data are published (although presumably the Fed has some idea already about this index since it is prepared by the Fed). On the same day, the Beige Book is published that will give an anecdotal characterization of developments throughout the country. On the 17th, we receive Housing Starts and Initial Job Claims data. Most of these readings tell us what has happened, and only inferentially, what will happen. However, an 'outlier' or surprise reading or two, suggestive of delay in the recovery, will virtually clinch the case to do more.

DOUBT: Immediately after the Attack, it appeared that politicians and policy makers were resolved to leave no stone unturned in righting the economy. The rapid resuscitation of the equity markets in late September and October was a vivid demonstration that markets were pleased by the decisive display of determination. Since then, in spite of a some notable military success and in spite of a remarkable show of confidence by consumers in response to attractive offers for new cars, other durables and an array of soft goods, doubts have emerged as to the shape and timing of the recovery. Worse, policy-doubt is in display with clear partisan carping over what is to be done and for whom policy should be set. Partisan politics might end at the waters' edge, but domestic economic policy is invariably a partisan That can only send signals of concern to spenders ---in the household and the business sector. The Chairman sighted both sectors by showing concern with the absence of profits to restart business investment and the damage that higher interest rates and reduced financial wealth could do to consumers. Some glimpse of the possibilities could come from the Retail Sales numbers tomorrow, while initial job claims may or may not validate a slowing trend to worsening labor market conditions. On the 18th the University of Michigan preliminary Consumer Confidence numbers will be available. Prior to decision day, we will see the Leading Economic Indicators, more job claims data, Existing Home and New Home Sales data. Finally, on the 29th, the advanced estimate for Q4GDP. The Bloomberg survey has pegged this at –1.3%. An 'outlier' on any of these could clinch the case for a further reduction in the Federal Funds Rate, because Greenspan is Determined.

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DETERMINATION: In the early years of the Greenspan era, he was often accused of being unclear, as he spelled out relevant considerations on both sides of each issue. The old saw that if people understood what he was saying, he was speaking too clearly, is much less apparent today. Friday's speech is an example of the priority he assigns to recovery and his determination not to shut off the policy engine he controls too early. It is a signal of his determination to see that this recovery is well established before the Fed quits the easing path.

The speech may have resolved some of the ambiguity as to when the Fed will pause, stop and then begin to 'reel in' the liquidity that has been created since last January. It is almost tempting to suggest that unless the data are overwhelmingly positive, the greater risk for Greenspan would be to quit too early. Greenspan surely would like a smooth upturn, not a double-dip that could lead to further doubts. He is determined to avoid that if possible. He may be the best politician in Washington, and a good economy is good politics.

There are now recurrent rumors that this is his last year at the helm of the Fed. If true, he would have an extra incentive to insure that a clear recovery is achieved and that it is recognized before his departure. The only blemish on his escutcheon was the accusation that he caused the defeat of Bush the Father in the protracted recovery leading up to the 1992 election. Having burned one Bush, surely he will avoid burning a second one. Two burning Bushes is one too many for the Chairman. Moses only got one!