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The Political Economy of Monetary Policy: Greenspan at HH 2004

The semi-annual Humphrey-Hawkins circus came back to Washington today, with the Greenspan the Lion King competing for time against the two, partisan clown claques that parade as the People's Choice. Asset markets around the world listened intently to the by-play for hints of future monetary policy changes. Our view is that hidden within the Greenspan show, is the high probability that the Fed will be sitting on the sidelines for the bulk of this year. The accompanying Monetary Policy Report presents a forecast that is upside on growth and downside on inflation. If the forecasters are right, there is no rush to grab the punch bowl. But even Greenspan admitted in his prepared remarks that forecasts go wrong. What was surprising in this performance was that there was no allowance for an overshoot---another bubble!

The major reason for this quite unusual lassitude is productivity growth, inexplicable though it may be. Greenspan produced another 'theory' for the amusement of the professional Fed watchers, as to the sources of this current productivity splurge, but in typical Greenspan fashion, the theory is quite untestable. It assumes its own explanation: namely that there was a huge buildup of excess and redundant labor caused by the cheap capital conditions of the last boom. And it is taking a long time to work off those excesses. Not only physical capital was excessive, but the labor that coordinated with that capital became excessive.

The current 'goldilocks' environment of extremely high productivity and slowing inflation (deflation?) would be perfect except that Job Growth has been much less evident than the growth of output and that spells Politics with a capital P! Particularly in an election year, no less. Or, unless the Fed leaves the punch bowl on the table too long and we get another Bubble. No one at the hearings asked that question. That must have been the Luck of the LionTamer, because his testimony provides no answer to 'what if you stay too long?'

Greenspan's Major Points:

?? The economy is definitely better than when the last circus came to town (July, 2003) and the prospects for a sustained expansion are quite good.

?? Job creation has made progress, but the gains to date are quite limited and inconsistent with historical patterns of output growth. Furthermore, despite the astounding flexibility of the U.S. economy and its labor markets, there are still a substantial number of people unable to find employment.

?? Productivity growth has been exceptional, but is probably not sustainable at its recent levels. The dark side of this surge has been exceptionally slow job creation. If productivity growth slows to historical levels, even to the higher rates of the pre-Boom period ending in 2000, job creation will correspond more closely to output growth.

?? Productivity growth is also the likely author of "sustained downward pressure on inflation," which while it has meant much higher living standards (real output growth), has also created a substantial barrier to immediate Fed action to raise interest rates.

?? Dis-inflation is strong in spite of the weakness of the dollar, contrary to the usual expectations, and there is now some evidence that imported goods and services are exhibiting rising prices

?? Dollar depreciation is not a particularly big risk for the U.S. economy and is unlikely to provoke a rapid conversion of dollar liabilities by foreign holders, while the depreciation itself will have the effect of reducing the current account deficit. . Dollar weakness as a cause of a sudden shift in the asset-holding preferences of

Central Banks is not even given consideration, nor is the implied rise in interest rates that would result from such an outcome, yet surely that outcome has a non-zero probability?

- There are still many risks that Greenspan admitted could upset the Fed's quite optimistic forecast for the next year such as an oil price shock, growth in the federal budget deficit and the pressure on interest rates in the future if measures to contain and reduce the budget deficit are not undertaken. The two deficits, taken together, could impose a high degree of policy inflexibility were the economy to suffer a severe shock in the near future. One outcome of the poor job environment could be even more severe outbreaks of protectionism that would "erode the flexibility of the global economy." Strangely, all the asserted risks are to the downside, as if the troubling Bubble just past has not caused any consideration of Upside Shocks. For a Central Bank Chairman who touts the role of the Fed as a risk manager, single-tailed outcomes seem an easy way out for a pre-chosen policy menu!

- Despite the risks, the prospects for "sustained robust growth are good," while" "Congress can help to reduce federal deficits," and thus "contribute to national saving" as well as promote more international trade. The Fed will use its policies to "promote our goals of economic growth and maximum employment of our resources in an environment of effective price stability."

Advising the Congress to beware the twin dangers of unrestrained spending growth and increased protectionism is a red flag for most of the democratic members of the House Financial Services Committee. It was thus an invitation for the clowns to entertain the crowd, and they did not pass up the opportunity. But, unfortunately for truly dis-interested observers, rather than partisan supporters, many of the Greenspan critics failed to move him away from his priority---expenditure control---and toward theirs---reversing the Bush Administration tax cuts. His argument was control expenditure first and then use tax policy to make up any remaining gaps. They didn't even flag him on the likely political connection that Pay-Go will require Tax Increases. Tame clowns indeed.

Quite aside from the partisan priorities, Greenspan could be faulted for failing to use this opportunity to recommend a wholesale change in tax policy, one that can escape the normal supply-side critiques of raising taxes on factors of production. What better opportunity will a libertarian like Greenspan get than to have Congress reflect on the possibilities of a wholesale shift from taxes on factors of production to taxes on consumption? That would tie Greenspan's concern over insufficient national savings and the unpredictability of the current tax regime to a more effective way to allow some net tax progressivity while eliminating a tax code that no one understands and everyone tries to evade. But he took the safe path by flailing budget excesses and not offering an alternative tax regime.

What's Left Out?

This hearing is ostensibly about monetary policy—despite the efforts of many Congressmen to showboat for their constituents, worker-voters or competitively pressed industrial contributors. A few thoughtful Congressmen worried about the growing moral hazard issues of GIE's and of increasing bank size while Representative Ron Paul, the Republican maverick from Texas, wanted to draw Greenspan into the potentials for world wide inflation coming from the unprecedented issue of fiat money in many, major economies.

What the Committee failed to investigate was the implicit return to a reactive monetary stance and the potential dangers that such a stance can pose. Somehow getting behind the curve was never discussed, either on the upside or the downside. That plays well into Greenspan's predilection not to be tied to an explicit regime of monetary rules, but if the Congress has a safeguard function on issues of excessive power, they went to sleep on it again. In an environment in which prices are scarcely rising and job creation is insufficient, the Fed's dual mandate can be honored in the breach---by merely sitting still, or in the new lingua franca, observing "patience." If, as Greenspan asserted, the 'villain' in the piece is abnormally high productivity growth, then the solution is to wait until it slows down---in spite of the admittedly unrealistic and unsustainable level of the real federal funds rate. Asking about the consequences of leaving that rate so low for so long was beyond the pale, at least at these hearings.

Congressional aides have done a poor job educating their Masters. Some saw the dangers of using the NAIRU such as Congressman Frank when he averred the positive correlation between the equilibrium NAIRU and falling unemployment…a correlation that makes the concept dubious for policy planning purposes. But the same sort of criticism can be levied against the Output Gap, which is in reality a transform of the NAIRU. Both concepts presuppose a known, potential rate of growth of output, and in a productivity revolution, that assumption is violated by definition. The consequence is that a monetary authority that wishes to be pre-emptive cannot be ---unless it targets something else than unemployment or prices.

What other targets might there be? Asset price levels, such as equities or houses or the falling cost of risk as evidenced by reduced corporate spreads? These targets are, however, are ***taboo*** for modern day Central Bankers. Greenspan admitted in answering one question that the Fed certainly watches these markets and tries to understand the implications of given asset price levels for future behavior of the economy. But, the Committee failed to draw out the connection and let matters drop. No one was bothered to wonder what happens if Greenspan's monetary policy reduces to serial bubble blowing.

When No One Knows, the Fed Reigns Supreme

Thus, at the end of the day, we arrive at a Fed that sits and waits, hopefully for job creation to massively accelerate, and in so doing tightens labor and product markets causing prices to begin rising and thus giving the Fed an excuse to remove its stimulus. When will that be? Probably not this year, but in fact, no one really knows. We can only guess. Will the Fed overshoot? Don't Ask and Don't Tell. Greenspan is certainly bi-partisan in preserving his own power and the power of the institution he has piloted for so long.