



Into the Breach: Greenspan goes from Monetary Policy to Social Policy

Whoever is chosen to succeed Greenspan as Chairman of the Federal Reserve will be walking in very large shoes. Greenspan's tracks cover the entire economic policy landscape. It will be a very long time before someone will be able to speak with such unflinching breadth. Today's first edition of the traditional Humphrey – Hawkins testimony (the Fed's annual Monetary Policy Report) was nearly shoved into the background as Greenspan parried the Senate Banking Committee persons who wanted to opine on the larger issues of Social Security, Tax Policy and Exchange Rates. We will leave for another Ecomentary to discuss these larger issues and confine our remarks to his actual monetary policy report.

Fundamentally, Greenspan showed his optimism about the future course of the economy. Growth appears to be steadier, notwithstanding the "soft patch" of mid 1994; employment is growing; prices and inflationary expectations are "contained." Economic growth in the past year has been powered by household (consumer) spending. His explanation of that spending performance rests on the expanded wealth position of households who have benefited from the effects of low interest rates. Housing prices have risen, expanding owner-equity and allowing both cash outs and a sense of security that has enabled households to save less and spend more. In the short run, lower household saving powers higher consumption. In the long run...

In slight contrast to the optimistic behavior of households, business spending while spirited is still laden with a cautious outlook not quite consistent with the expanded profits and improved balance sheets of the sector. His expectation is that business **capex** will provide more impetus to growth in the months to come, but he offered no really new explanation to why the "exceptional rise in profits and internal cash flow(s)" have not stimulated even greater capex or expanded hiring.

In contrast to the "real" side (business investment), financial markets have been exceptionally confident and willing to finance risk to an extent that actually has worried the Chairman. "... the exceptionally low level of risk spreads in credit markets," is the "conundrum" Greenspan has searched to explain (unsuccessfully?). He noted that while in the past, when the Fed has begun to raise short term rates, long term rates have normally followed. That has not been true this time. In fact, the curve has flattened sufficiently to bring about declines at the long term end while the short end of the curve rises. This puzzle got more than cavalier attention, because if financial markets are excessively buoyant in the face of the 150 basis point rise in the target Federal Funds rate in recent months, the market will have to judge from these comments whether the Fed could perhaps bring even more pressure to bear than is currently built into the rates.

The flattening behavior seen here, however, is a global phenomenon. It is not confined only to the U.S. Is this a result of market participants operating on the theory 'the trend is your friend?' There has been a long period during which inflation has been stripped out of many economies. Is this a result of "globalization?" Greenspan is dubious on this score, but he isn't really sure how to interpret the apparent willingness of the Bond Market to avoid increasing risk spreads or the anticipated level of longer maturity bonds.

This could be interpreted as Greenspan's 'threat' to defeat a "Bubble," but he was very careful on this score. The quiescent behavior of the long end of the curve, however, has led Greenspan to worry in public if financial market participants are also "complacent." To some, his concern mounted to an explicit warning to the financial trade to be a bit less incautious.

"Yet history cautions that people experiencing long periods of relative stability are prone to excess. We must thus remain vigilant against complacency, especially since several important economic challenges confront policymakers in the years ahead."



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In other times, one might call this 'jawboning,' but since he used a "conundrum" to punctuate his uncertainty over the cause of compressed risk spreads, he has left the market with considerable room to speculate either way. The Fed could go faster or slower in its present course. He left his options open. This may be a clever way to introduce a bit more uncertainty at the long end (and thus create higher rates without having to raise the Federal Funds rate). Ultimately, however, even the best 'conundrum' won't substitute for a tighter financial environment. He knows that as do the CarryTraders. For now, no shots across the bow, but no "fat lady" singing either! Whoever the new Chairman, he will have to concern themselves with this adroit ambiguity that Greenspan has introduced, unless circumstances take him much further down the road to removing accommodation and the new Chairman will be constrained by policy momentum.

The longer run issues that became the real focus of the hearing are the required fix for social security, the human capital requirements of the U.S. workforce and the potentially destabilizing aspects of a shift in the distribution of wealth and income that come from a more open world trading economy. During the past several years, productivity growth has helped keep incomes rising and inflation contained, but it appears to be slowing. If that turns into a secular trend, then balancing the needs of older and retiring Americans against the lower level of income taxation and the still not contained Federal budget will become much trickier and will have a greater degree of divisiveness. Greenspan is deeply worried that the Congress will so politicize its deliberations that nothing will be done. The clock, however, is ticking very loudly. Tough decisions will have to be made. He expected the questioning and he wanted to direct the traffic.

This was the sandbox in which the Senators wanted to play. Other than a few clever questions about how to define the 'natural rate of interest' or the 'equilibrium real Federal Funds rate," the HH testimony was an occasion for both parties to espouse what they think their constituents want to hear in reference to social security and tax/expenditure policy. A consoling and sober note was introduced into the fray when Greenspan noted that in the 1983 Social Security Commission report, a consensus was achieved that allowed only a vote up or down on the entire report. That forced compromise. That seems an unlikely outcome this time, but it was engaging to hear the Chairman wax longingly at a time of greater political comity.

At this hearing, monetary policy was given short shrift while the level of pontification on broader social policy expanded. This is the Gresham's law of Congressional Hearings, bad advice drives out good advice. Clearly this Chairman is not only the most adroit the Fed has had...he is the luckiest!



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MAS021605

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