Munk Advisory Services

ECOMENTARY™

MAS 041305

Conundra of Ignorance: Minutes Reveal What the FOMC Doesn't Know

When Greenspan introduced the risk-heightener, "Conundrum," students of macro-economics were treated to a new concept in Central Bank Policy Tools: the deliberate use of ambiguity to heighten perceptions of risk. This is one step short of a Central Bank that has an explicit eye on asset values. It suggested to the bond market that the day of reckoning was coming. Of course, the date was left imprecise and the level of reckoning was left vague. Ethnologically oriented macro economists will remember that the verb for counting up a sum in German is 'rechnen." One might suppose that the legacy of the old Bundesbank was at work on the Chairman since the conundrum clearly referred to a "rechnung," even if the "tip" was not specified.

But that was then, and yesterday was now and with it came the Delphic meanderings of the FOMC trying to be transparent about a subject that they truly know less than one might expect. In the grand tradition of another loquacious governmental spokesman, "less is more," and the FOMC minutes for the March 22nd meetings amplified that lack of clarity by beating around the bush that cloaked their ignorance.

The essence of the Fed's problem is threefold: First, it suspects but is not totally sure that inflation is a bigger threat than it has been at any time since the more zesty climes of late 1999 and early 2000. But, it is not totally sure. So to speak, there is some asymmetric risk working itself out here. If the Fed were to neglect to tighten sufficiently, it fears that inflation would in fact turn out higher than the market had anticipated That would not be bad were it not the belief of at least some members of the FOMC that disappointed expectations on inflation by the market will accelerate forward expectations of inflation. This is a curious kind of asymmetry. The slope of the expectations curve is asserted to show a rising second derivative---at least above the current level of inflationary expectations. A curious saddle point for those supposedly in the "know." Second, the Fed realizes as do many of their economic brethren outside the hallowed halls of the Mariner Eccles building, that rising oil prices are a tax (of unknown impact) on the incomes of households as well as a likely dampener on the animal spirits of entrepreneurs. The problem is that the rapid escalation of oil prices to newer and more commanding heights have not eaten into the animal spirits of consumers, at least not to any observerable extent. And, businessmen seem intent on spending as well. The budget constraint suggests that must mean even lower saving and current theory suggests that higher spending and lower real income could only arise from public perceptions of growing wealth (housing and equity prices). That reeks of Bubble with a capital B. Except for the Fed's propensity to say it is not in the asset price regulation business and that a famous Chairman once told us we would know a bubble only after it was over, how could that be a problem? Now to which Conundrum did the Chairman really refer? Third, monetary policy is supposed to head toward a 'neutral' real rate of interest which is to say be less accommodating as the perception of inflation risk grows.

The market knows all that, but it doesn't know what the nominal rate of interest ought to be to bring about a 'neutral real rate.' And, worse, the market doesn't know just how fast the rate of climb ought to be. So much for Bond Market uncertainties. The Real Problem is that the Fed doesn't know either and the stated goal of transparency requires that the Fed publish the minutes of its FOMC deliberations. What we had yesterday was an escorted tour of FOMC speculations and fears and uncertainties. Their ignorance was as palpable as ours.

"Who's on first?" Abbott and Costello used to chime. Since the Minutes were so mixed, a mixed metaphor can be allowed: "Only the Shadow Knows" about the level of rising real rates necessary to make monetary policy less accommodating and given that knowledge, only the Shadow knows whether not being more aggressive than they have been to date will require the FOMC to go even higher than what they once thought was the nominal rate equivalent of that famous neutral real rate. Confusing? No, just another set of Conundrums (Conundra?). Maybe they are only spring flowers so we should appreciate their seasonal beauty?