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"It's the credit markets, stupid!"

Some say it was the bad payroll number that finally moved the FOMC---or alternatively, gave it 'cover' to do something. We believe it was a confluence of concern, which is why the "implied probabilities" of a Fed cut were so low! Diffusion was concealment. We suggest, however, that it is the credit market that holds the key to why the Fed acted today.

First, we note the risk entailed by an investment boom collapse and the asymmetric risk posed for the economy if consumption and housing would not be sufficiently strong to keep the economy from declining even more severely. The asymmetry comes because the risk of inflation was far less than the risk of recession.

Second, it is abundantly clear that the U.S. economy is the driver for the world and that means that no help for the U.S. could be expected from other centers of world economic activity. The failure by the ECB to cut, and the emasculation of policy in Japan, emphasize that U.S. exports could not be expected to grow sufficiently to offset the slowdown in U.S. investment spending. That leaves U.S. fiscal policy, now mired in a politically debilitating debate over the nature and extent of a tax cut.

With the debate over the tax cut dragging on, the sole lever for policy change to offset the forces of recession stemming from the collapse of the investment boom was a far more timely and aggressive monetary policy. What was needed was a 'forward looking view' of the economy that is Greenspan's characteristic modus operandi when he can achieve some consensus of fellow FOMC members. The key problem was surely how to build such a consensus. We note that Greenspan has been remarkably quiet during this period. That is a characteristic behavior pattern of Greenspan. He lets the other guy speak!

Every observer has noted the lengthy debate waged among FOMC members during the past several weeks as evidenced by their public statements. Several FOMC members were arguing in public that intermeeting cuts risked the integrity of the policy setting process. While Greenspan always wishes to be 'forward looking,' it is also clear that he cannot act alone. He needs to build a consensus particularly when interrupting the normal policy setting process. While Fed Funds rate behavior implied a rather low probability of an FOMC change, surely there was an ongoing evaluation about risk. What was it in the pattern of the economic data flow that tipped the scale?

Consider the following. The continual mark down of revenue growth and corporate profits by equity analysts that produced a forward-looking picture of considerable risk to investment spending. Second, there was the payroll number that was negative (-86,000 as compared to a consensus expectation of 60.000). Inflation numbers were benign to say the least with drops in import prices (particularly in petroleum prices). Consumer expectations continued to drop.

We don't know at this time what it was that brought the a majority of the FOMC to a view that the risk of overshooting on monetary ease was less than the risk that the economy would backslide into a true recession, but we do know that Greenspan focuses on financial markets.

Remember September 1998? He worried about the surge in credit spreads and the dangers to liquidity coming from the Russian default and the problems with LTCM. Then, remember his outspoken speech on December 5th to the banks and other credit institutions that warned them not to 'seize up.' That was a warning to his colleagues on the FOMC to do something at their December 19th meeting. The FOMC was feckless, and they did not cut rates although they signaled a willingness to do so with a 'two move' jump downward in the 'bias.' That led to the inter-meeting cut in January and a second cut at the end-January FOMC meeting. If credit conditions are the key, what has been happening in our credit markets? They have backed up...

Worse, look at the slug of debt in the Hi Yield market---coming from one of the former leading edges of technology investment---the Telco's and their associated suppliers. There are already bankruptcies and there will be more. The long end of the curve has moved up, but hi yield spreads have 'blown out.' Some estimates of the impaired credit volumes (Telco debt) run to 250 billion or more. This could be the tip of an iceberg much like the S&L collapse of the late 1980's.

Greenspan got his baptism under fire with the October 1987 stock market fall. He responded with a very prompt and sizeable change in monetary policy. Further, he communicated to key money market players that the Fed was there with "more" if needed to prevent a disaster. That was the first experience. The cleanup of the S&L's and the restructuring of the financing of real estate also happened relatively early on his watch.

What seemed like a monumental problem turned out to be workable. To insure that the restructuring took place, the Fed created a significantly sloped yield curve that refinanced weakened banks in the U.S. He spoke of this period as a period in which the Fed was fighting financial "headwinds."

The Telco debt is substantial and it impacts much of the leading age of technology. Technology was the driver that got Greenspan to be relatively patient during the boom...that productivity thing. It is still in his thinking and it is mentioned again in the statement today accompanying the intermeeting cut.

The warning is clear to other FOMC members. 'Don't risk a long collapse in technology. That is the key to growth in the future.'

It's the credit markets, stupid!