Munk Advisory Services

ECOMENTARY™

MAS052004

Measure for Measure

At this juncture, with inflation low and resource use slack, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. FOMC May 4, 2004

And, what does 'measured' actually mean, Chairman Greenspan? When we evaluated the statement after its release, we concluded that it was a statement with little commitment to a prescribed path of tightening. It merely evaluated the risks as balanced and promised to take steps appropriate to the situation at hand. Or, as we said at the time, to paraphrase an old advertisement: 'The Fed will sell no rate change before its time!' Nor will it sit patiently if inflation breaks out! It will measure, then pour.

Recently, some commentary on the bond market has focused on the Fed's likelihood that it is already 'behind the curve.' The implication of that charge is that by the time the Fed is ready to act, inflationary expectations will already have become deep-seated. Further, so that thinking goes, the Fed will be forced to move with greater force and perhaps with greater rapidity in order that its hard-won credibility as an inflation fighter not be lost. Were that the case, the Fed could rightly worry that its hand was being forced and it would not be able to respond in a measured fashion. It's wish to be measured in its pace of "dis-accommodation" would be hampered by having to assert its control over the inflation process by a rather sharp and perhaps heavy hand. This Fed wishes to lead, not be led, and it will resist being flayed by the Bond Vigilante's pre-conceptions.

How can it do this? By telling the market that its path of removing accommodation will be measured. It then hopes to allay expectations---to defuse the bomb of inflationary expectations. The Fed wants to look at the situation at hand and respond in a fashion appropriate to its purpose—dis-accomodation in an orderly way.

The operative issues are Can it Do So, if so, How?

Two important members of the FOMC, William Poole, President of the St. Louis Federal Reserve Bank and Ben Bernanke, a member of the Board of Governors of the Fed have come forth recently with some rather succinct views on the path and process of Fed response clearly written for other members of the FOMC to think about, but also as signals to the market itself. Poole's views were first expressed in a speech on February 25th 2004 and were later published in more extensive form in the Federal Reserve Bank of St. Louis ***Review***, January/February 2004 under the intriguing title, "Best Guesses and Surprises." Bernanke's views, entitled "Gradualism" were published May 20th as the text of a speech given in Seattle. Both papers contain a great deal more than we can review in a short piece, but here is a partial distillation.

Poole

In our view, Poole is trying to take the argument of "Fed behind the curve" away from the Bond Market. He attempts this by focusing on how the FOMC does its work. First, the FOMC starts with a consensus view of where the economy is at a given point in time—its estimates. Second, the FOMC (ought to) lay out a clear guidance on "policy," that is some sort of guidelines on how it will respond to various circumstances and how it will seek to implement that response. That is "policy," but the specific step it takes—the value of the response—is a "policy action." He rejects any simple application of a Taylor rule, however much that formulation has found adherents. Starting from what he terms the "consensus," he then considers the actual events, the deviations from that consensus---the Surprises. The fact that forecasts go awry doesn't mean that forecasting is useless. It provides a template or a filter through which the actual events of the day can be compared. "Forecast errors," Poole says, "create risk, and that risk needs to be managed as efficiently as possible." As new information becomes available, policymakers will "adjust their view of the appropriate policy stance. **If the revised view of the appropriate policy stance is sufficiently changed, policymakers can and should implement the changes in policy settings, such as the intended federal funds rate, that they believe are consistent with the new information." (emphasis added).**

This is a direct rebuttal to any kind of simple view of where the Fed sits with respect to the "curve." The Fed is not 'behind the curve' if new data arrive with a policy setting that still has to be changed. The Fed can only get behind the curve when the New Data is not linked to a clearly communicated policy response. A "measured" pace is exactly that---measure the difference between the previously held consensus and the actual data point, and respond in a 'measured' fashion. But, clearly, communication has to be clear. The market must know how the Fed sees the data and in a sense **why** a measured response could be different from an earlier expectation held by the market. This opens the way for a great deal of flexibility in response by the Fed. It is an escape hatch, so to speak, from the charge of being 'behind the curve,' but only when it is clearly communicated.

Note that this process does not require market "preparation," before the change. It requires communication of the reasons that a particular policy action was taken. When, for example, an unforeseen 'shock' occurs, the Fed can respond and explain its reasons for responding in the chosen fashion. "Given the shock, the FOMC's action ought not to be a surprise."

Poole then goes on to give a kind of catechism of "principles," that cover how the FOMC would respond to certain shocks. These include warning the FOMC not to act in response to very transitory shocks, but to react clearly to those that are highly persistent. Some shocks are the data values themselves---as opposed to what the consensus about such values was prior to the arrival of the "news." Some data have high measurement error, so the response ought to take that into account. Some data could be seen as conflicting either with the Fed's dual mandate (employment growth and stable prices) and some data could relate to the possibility of financial instability. In short, sort, measure and then, pour!

Bernanke

The Bernanke speech, "Gradualism" attempts to give a coherent set of reasons as to why the typical Fed response is a gradual approach. This is to be contrasted to the "Cold Turkey" approach in which a Central Bank 'knows' what the appropriate policy setting is, and wastes no time in getting there. (I like to call this the Kudlow/Roach solution because both have advocated a Fed approach that "gets it over with!"

The case for gradualism is often made because of the uncertainty of the data and uncertainty about the model. Consider the uncertainty that arises from not being sure how a Fed policy change will affect the economy. "Go part of the way," says the Brainerd Theorem where such 'model uncertainty' exists. But, even that well-known result is dependent upon a particular specification of the kind of uncertainty faced by policymakers. In some cases, being much more active or stronger in response, will be the more appropriate reaction.

Another leg in the Bernanke argument for gradualism arises from the observation that expectations "play a crucial role in the determination of long term interest rates and other asset prices and yields." Thus, the case for gradualism can rest on the argument that a small step can condition markets to anticipate what policy changes will be taken in the future. This gives the Fed even more power over long term rates---because it can affect expectations. While the Fed really only controls a single rate, the Federal Funds rate, the interaction of that rate and expectations about its future course, will affect the entire term structure and rates for other asset classes. In part, the Fed's power to affect expectations stems from its communications policy, that is how it sets out the case for what it sees and what the Fed's response is to that particular assessment.

A third leg in the Bernanke approach is that a gradual approach to policy settings will lead to more financial stability---that is to say that "shocking" the market can lead to instability because the market neither 'expects' nor 'understands' why the Fed has gone "cold turkey." Here there is a crucial link to the Poole argument. Both Bernanke and Poole wish to use the market's propensity to forecast the future as a strong assistant to Fed Policy Changes. They want the market to forecast the future and to see the Fed's latest policy setting as a forecast of what the Fed thinks will happen and the steps it will take to have the economy on an appropriate path. Note, however, complete predictability is an impossibility, so it is to be expected that the Fed will have to change its policy settings as new information arises…precisely the Poole point made earlier.

Measure for Measure

We view both of these speeches as being directed toward financial markets. Both policymakers want the markets to understand that there is uncertainty in the data stream, uncertainty about the forecast (it is a forecast, not a certain value) and both kinds of uncertainty entail risk for the economy and for the actions of the policy maker. Both are also implicitly addressing the frequently heard argument about the Fed being "behind the curve." Whether the Fed is 'behind' or 'in front of' critically depends upon one's own forecast of future data points. Perhaps more importantly, taking a measured response does not rule out acting vigorously or acting insufficiently at a certain point in time, only to be more aggressive if the data suggest that more aggressive responses are needed!

The groundwork is being carefully laid by some distinguished monetary economists for markets to more effectively evaluate future Fed policies. There is no commitment to a 'gradual' response. What there is a commitment to be highly communicative when the policy settings are changed; to make the market serve the purposes of policymakers. "Getting behind the curve," is in this view a kind of market sophistry. Unless one is sure about the value of future data points and the precise linkage between changes in monetary affairs and the affairs of the real economy, the markets are being warned not to make a presumptive call at this point. Both economists view the necessity for moving to a more realistic Federal Funds rate, but perhaps more importantly, to clearly communicating the reasons for whatever changes the FOMC will next make. Who can object to that kind of transparency?

ECOMENTARY? is published for clients of **Munk Advisory Services, LLC**
955 Mt. Moro Road, Villanova, PA 19085. tel (610) 527 5368 fax (610) 527 5068

Website www.ecomentary.com. Contact: munkb@ecomentary.com

Munk Advisory Services

ECOMENTARY™