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Back To School

We owe readers an apology for our take yesterday. In reading the Greenspan speech, we essentially ignored the comments that appeared to indicate a subtle warning to markets and which seemed to have received wide press coverage today. Instead, our focus was on his inflation mechanism and his explanation of why he sees less risk from suddenly escalating prices. However, the extent of market commentary focusing on his view of the Fed as it awaits the newest data on price behavior, requires some comment on our part. We reprint below the two, key paragraphs with which he closed his message.

> ***Economic developments going forward will determine the level and term structure of interest rates. Federal funds futures prices already reflect expectations of a substantial firming of policy by the Federal Open Market Committee (FOMC). Unlike 1994, there has been an appreciable increase of market rates in anticipation of policy tightening, though history cautions that investors' anticipations of the cumulative magnitude of policy actions and their timing under such circumstances are far from perfect.***
>
> ***Lastly, let me emphasize that recent financial indicators, including rapid growth of the money supply, underscore that the FOMC has provided ample liquidity to the financial system that will become increasingly unnecessary over time. The Committee is of the view, as you know, that monetary policy accommodation can be removed at a pace that is likely to be measured. That conclusion is based on our current best judgment of how economic and financial forces will evolve in the months and quarters ahead. Should that judgment prove misplaced, however, the FOMC is prepared to do what is required to fulfill our obligations to achieve the maintenance of price stability so as to ensure maximum sustainable economic growth.*** (Greenspan June 8th 2004)

There is no doubt that Greenspan is "alerting" the market to the idea that the current mantra (measured) should not be taken to **exclude** raising the Federal Funds rate by more than the conventional 25 basis points or that the "path" to dis-accommodation could involve a more rapid ascent. What governs are the behavior of the economic data and the requirement that all Central Banks have, namely the "maintenance of price stability." We can add a few observations in this regard.

1)How could the market not know this as of June 8th 2004? Greenspan has always said this and he reiterated his pledge at the JEC hearings in April. Further, he noted the same fundamental idea in his recent letter to Senator Sarbanes. He knows that 'credibility' is an essential tool of monetary policy and his colleagues on the FOMC do also. He is not quite clear whether it is a data surprise or an acknowledgment of what might occur that invokes his interest.

2) Using the language of St. Louis Fed President Bill Poole, the recent inflation data have "surprised" the Fed. Core prices seem to be moving more rapidly than the Fed's consensus expectation. If the Fed's "current best judgment" is misplaced, the Fed will be forced to do its duty. This speech amplifies some of the reasons this may be occurring and concludes by sending the Central Bankers's equivalent of Nelson's famous remark, "England expects every man to do his duty" to the market. We focused on some of the reasoning that accompanies the price surprise.

3)Greenspan draws a distinction between the 1994 case and the current situation by pointing to the fact that the market has already been considerable anticipation of the tightening to come and it is reflected in the current term structure of interest rates. But, he lets the FOMC 'off the hook,' with the proviso that "… history cautions that investors' anticipations of the cumulative magnitude of policy actions and their timing under such circumstances are far from perfect." Here the issue of path toward the (unknown) equilibrium real federal funds rate is clearly laid out. It is not Dante's warning to abandon all hope, but it is clear that if the data tell the

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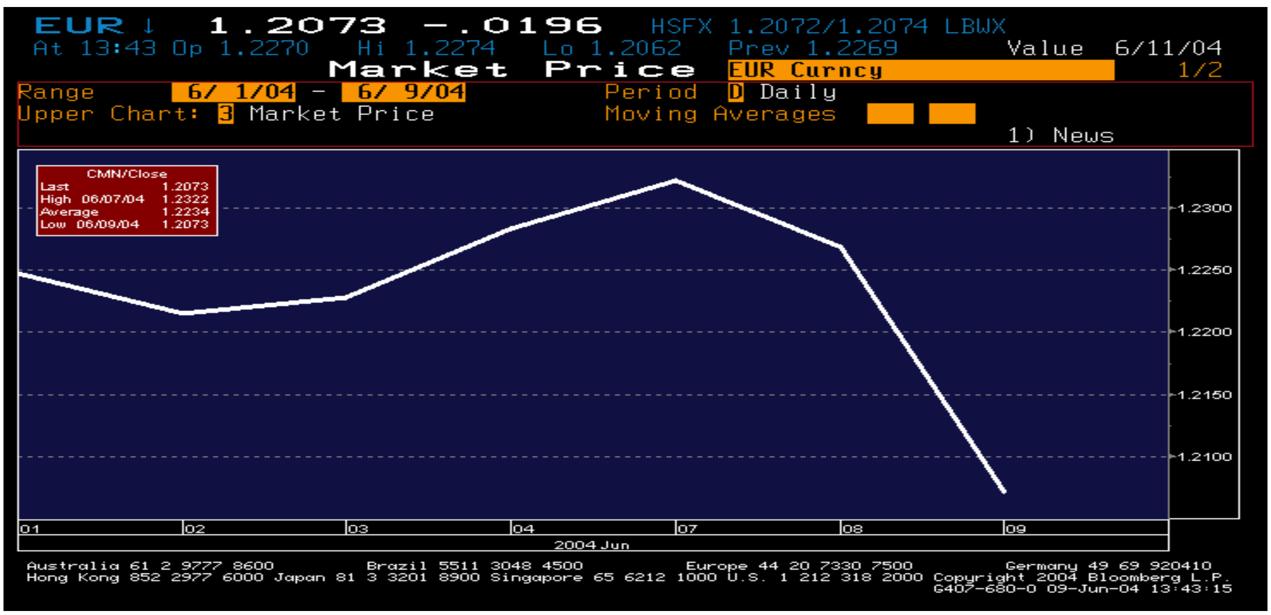
FOMC it needs to move faster and harder, it will do so.

4)Finally, the Fed has no intention of leaving excess liquidity in the system any longer than is compatible with price stability, even though "monetary policy accommodation can be removed at a pace that is likely to be measured." In other words, the Fed is not about to suddenly sell huge amounts of paper and drain off liquidity willy-nilly. It will nonetheless do its duty if the data point out that duty. .

We erred in not drawing sufficient attention to this shift in emphasis if you can call it that. We didn't see it as a shift, but perhaps it was relevant to point out that by laying out the FOMC's "duty," Greenspan was allowing for a surprise in the data that would force the FOMC to move more rapidly than *perhaps* the market had believed.

Market Beliefs

Not surprisingly, the FX market "got it" with a large change in EUR and JYP since the speech was given.



Similarly, but perhaps less dramatically the yield curve has begun to move, but only slightly and Fed Fund Futures for December have now allowed for at least a 2.25 Fed Funds rate with 2.50 implied for January. While the move is noticeable, it is perhaps not as drastic as the coverage in the press might have indicated. It does seem on balance that the FX and Interest Rate markets did some adjustment to the possibility that the data could come in that would justify a less measured course by the Fed. Stay tuned

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