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Changing Paradigms: deflation watch to inflation alert

With the Greenspan speech on June 8th that made it perfectly clear to markets that "measured" doesn't mean the Fed will shrink from its duty to be vigilant on the inflation watch, the rush to 'get on board' from other members of the FedSpeak community has become a deluge. Kohn, Geithner, Guynn, Pianalto, and Poole have all chimed in as the FOMC attempts to defeat any thoughts by the market that the Fed is behind the curve. The FOMC seems certain to make the first raise on the return to monetary neutrality on June 30th. In fact, with so much public talk concerning its willingness to act, the FOMC has almost stumbled into pre-commitment. That said, however, a number of items are left to be organized.

1. magnitude of first step, the "level" of a neutral funds rate and the "path to neutrality.'
2. surprises in the data that could change the steps and the path
3. the global context
4. the possibility of an overshoot on the tightening side

Magnitude and Path:

The market is quite undecided at this point as to whether the first step up is a 25 or a 50 basis point move. That is not surprising since on the FedSpeak evidence, the FOMC also seems undecided. Worse, the FOMC has really not outlined a case for a specific kind of "path" other than to come forth with the "measured" mantra and then have that mantra trashed by the inflation data itself. Tuesday, we may know more with the CPI data. The consensus at Bloomberg is 0.5% topline and 0.2% core on the CPI and 2.9% and 1.8% for the YOY measures. The consensus on the PPI is 0.6% MOM topline and 0.2% MOM on the core.

Surprises

By Tuesday, markets should know what "surprises" the Fed must deal with. So far, however, wage and benefits data are "surprising" the monetary policy planners. As we have suggested before, the formal debate behind the scenes will involve assessments of the rate of productivi ty growth, whatever passes for the "potential rate of growth of the economy," and the implied path of prices, wages and employment. All that and an assessment of how market expectations of inflation are shaped (adaptive and/or rational), as well as some consideration for the likely course of the economy in 2005.

Global Context

The BOE raised their rate last week to 4.5%, a rate change clearly buttressed if not caused by the explosion in housing prices. That makes 0.75% since the beginning of this year. The ECB remains a mystery child over whose legitimacy of function, few wish to claim parentage. The Chat is next year, next year, but EU inflation rates really never came down much. Then, the riddle of Japan whose real economic growth rates recently are causing some deep rethinking. At the least, the BoJ is now forced to claim it is not suddenly going to leap into the rate-raising fray. The official statements are clear. Japan is not quite ready to declare victory in the war on deflation, some market players have become doubting Thomases. The 30 year swap rate is escalating quite sharply. And, the new star in the East? China has used a series of steps to tighten, more in the line of credit controls and jawboning of large banks, but clearly indicating that Chinese planners wish to chop out a significant amount growth exuberance, rational or no. A great deal of liquidity has been pushed into the world market by the tandem expansion paths of most Central Banks in response to the great fear of deflation. As inflation becomes a concern, the same countries will be tempted to join the new game---fighting inflation

Overshoots

The “newest, best thing” is likely to be overshoots by several CB’s (even the Fed). With U.S. fiscal policy likely to tighten into the next year, some will begin to wonder (if they have not already) if central banking history will be repeated----overshooting the target. It is an interesting exercise for ‘thinking out of the box.” We shall be exploring this topic in more detail but it is interesting to think about as you sip your morning coffee.

1) What if the Fed clamps down to hard this year, in order to keep the Bond Vigilante's from chanting, “behind the curve?” It is not beyond the pale to think that the removal of the two fiscal stimuli (tax cuts and depreciation guide lines) and a likely slowing of housing could be consistent with a slowdown growth wise in 2005. Would that cause the Fed to slow its tightening phase? Would the Fed seek to ‘restore credibility’ to such an extent that it provoked the need to loosen somewhat later in 2005?

2) Is it possible that the BoJ sits tight on ZIRP too long and is then forced into an earlier and more aggressive tightening phase? With still unresolved banking issues? Another interesting mind stretcher.

3) What if the recent agreement between the PBOC and the CME through which a futures market in the RMB is likely to be initiated signals a much earlier opening of capital markets in China? The conventional wisdom is that the RMB is undervalued, but a significant capital outflow from China would lead to a depreciation of the RMB? What are the PBOC gurus really thinking?

This a time for rethinking macro assumptions, a time to think out of the box because as we all know, markets are a continuous source of surprises—especially to policy makers!

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