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The Monetary Policy Debate: levers and jawbones

Whatever the outcome of the FOMC's deliberations today, economic historians will note the parallel to an 'ancient debate,' as the Fed attempts to cope with the recovery from a Bust. The Bubble that preceded that Bust was a like A Hundred-Year Flood, and the real debate is whether normal reclamation measures are the appropriate remedy for such a flood. There are parallels to the 1920's boom as well as its aftermath, but there are also clear dissimilarities. No one would compare the 1.5/2.00 % growth rhythm of this recovery with the elongated disaster of the 1930's, nor should one ignore the difficulties that Japan has faced in trying to rescue its own economy. The Fed has already told us through a major staff paper that there were lessons to be learned from the Japanese experience. The question in our mind is which is the relevant lesson? Too little, too late? Or, possibly the great dangers posed when a Bond Bubble is created to fight the Bust?

Of course, one does not expect a member of the Fed to say that the economy's 'macro problem' runs beyond the capabilities of this Central Bank. That would be institutional suicide. Yet, there are many skeptics of the potency of monetary policy to cope with a Bust that follows a Boom, absent a Great Liquidation. The Fed's rather prosaic statement style will unavoidably be parsed by every analyst today, whatever the outcome on the rate decision. Our own view is that the Fed will take a modest course and cut the target Federal Funds rate by twenty five basis points and attempt to nuance its expectations "lever," with language that 'commits' the Fed to sustaining low (or perhaps even lower) interest rates until even a very small risk of deflation has gone to zero. Will that take the economy back to its full employment equilibrium? Monetary theorists will find a vigorous debate at the end of this story, one that may last as long as the post mortem of the Great Depression. Why? Because, no matter how this cake is cut, two central issues lie buried beneath this woodpile: the neutrality of money and that hoary issue of 'instruments and targets.' The latter category actually involves two separate problems that are not insubstantial. The first one is whether the Fed actually possesses a second instrument to pair with its twin targets of price stability and maximum sustainable economic growth? The second one, latent though it may be, is whether modern day transparency requires putting the Fed on a "rule" or whether it should always have a discretionary setting ("flexible inflationary targeting). If the latter, then how the rule is applied in these special cases will have to receive more treatment.

The Fed has already stepped into the morass with the revision of its statement on May 6th. It now openly addresses both targets (inflation and growth), but it has yet to clear the air completely on how to weigh one goal versus the other or how it thinks the economy actually behaves in running between this rock and a hard place. Our old friend, "neutrality" lurks beneath this woodpile, however nuanced the statement may be Even if one gives up and admits **Money is Not A Veil** (particularly off the 'equilibrium" path), a Central Bank seeking to use transparency (risking its credibility) as the cutting edge of its 'expectations lever' will have to step in the forest and throw light on the issue of what the path looks like as you approach it (or get very far away from it). Here comes Mr. Zero Bound again and we are not sure if he is Frosty the Snowman or Wicked Witch of the North! We doubt the Fed will tell us how to recognize the difference, but it must be implicit in whatever decision they take today.

A central tenet of Austrian economics was that the recovery from a Bust that followed a Boom was the financial and physical capital cleanout often referred to as the Great Liquidation. The quaint colloquialism is that "always ends in tears." When such a liquidation took place, enough capital was destroyed, financially and otherwise, to allow prospective rates of return to capital to rise and stimulate new investment. It is the discrepancy between the perceived, ***ex ante*** real return to capital and the current cost of capital that allows the investment engine to restart once gain. This Fed has essentially denied that older 'wisdom,' and clearly believes it can nudge the economy back into a recovery mode, even without a Great Liquidation.

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All of this is to speak about the unspeakable. Today the Fed will not tell us what it cannot do (the neutrality of money issue will be left in the corner, hopefully not to interrupt the proceedings). What the Fed will do, and by implication, what it is willing to do to promote recovery is the best we can expect. When recovery will take place will still be unknown, particularly if what one means by recovery is a sustainable growth performance in the 3-4% range with no inflation. Markets, in the meantime will continue to price bonds and equities on their 'view' of the timing and quality of recovery, and in the shortest of runs, on what they think Dr. Greenspan really 'thinks' about these vexing conundrums.

We have been here before. We are now looking for a new Greenspan mantra. Greenspan has always found a new theory to fit the then current, somewhat inexplicable set of circumstances he believes the Fed faces. As we all remember when he lavished praise in 1999 on the technology boom and the apparent reconciliation of very high growth and stable prices. He surely can recognize the Bubble past, and he can still remark that one knows one has been in a Bubble after it has past. Whether a Central Bank should try to prevent the excesses of a Bubble and more importantly whether the relief of the Bust can be found in interest rates that have plummeted to 40 year lows is both a question of theory and history. The ***Fedspeak*** of the last few months has adduced a new 'instrument,' the explicit use of announcements and speeches. If this is the new Archimedean lever, the markets are going to have to judge whether it is indeed long enough to lift asset prices on a more permanent basis.

The Central Bank's perception of what was going on and how it should deal with it will provide the grist for mill of monetary research for next several decades, much as the Great Depression provided much of the research on monetary affairs in four decades following World War II. The language and texture of the current 'debate' over inflation targeting, flexible inflation targeting or whatever the current thinking on the application of monetary policy to cyclical disturbances is called has become very confusing to the market. This threatens the credibility of Fed Policy---not because the Fed is pursuing the wrong path---but because the market is uncertain what path ought to be pursued. Perhaps, and more fundamentally, the market is confused by what it "thinks" the Fed "thinks" is the right path to pursue. We will have to await first the Statement at 2:15 today and surely some speech in the near future as Greenspan outlines a theory of monetary response to the Bust.

Can an economy having passed from gigantic Boom to Bust get on it with it once again without descending into a Japanese purgatory of deflation, hollowed out financial core and the threat of an ever-increasing budget deficit to finance the welfare of its aging labor force? The U.S. has not (yet?) experienced the first two of this unholy trinity, although any reasonable forecast of the exploding budget deficit makes some parallel with the Japanese experience.

In the old days when Central Banks were not independent but merely the mistress of their country's Treasury, an expanding budget deficit meant inflationary finance. Theorists argue whether such a circumstance is Monetary or Fiscal policy. Whatever you call it, it pointed a direction out of the forest. Or will it in all circumstances? The rub here is that by pushing the curve down to absurd levels, something must happen to the expectations of economic units? If they think this is the future, how do they view the issue of savings? Do they think that they will ultimately have to pay the Piper in the form of higher taxes, or can they, as seems to be the case in the U.S. rely on an unenforced labor border to add to the taxpaying pyramid for their old age and just buy another new car now? We've not been here before and we are then left to theorize. That is a dangerous basis for market timing.

The Fed has spoken a lot about what it has or could learn from the horrid Japanese experience. Reduced to a one liner, it is "Act quickly and forcefully." However, we are well into the third act of this play. How much force is left? More importantly, hasn't the Fed built a constituency in the Bond and Mortgage markets for every higher asset prices?

If we were the Fed Chairman, we would have the answer. We will know if the Greenspan (alias Hayami) put condemns us all to an ultimate Great Liquidation when it has past. Rue the day we live so long!

Expectations are now the new lever. Will it be long enough to do Archimedes' work? Some critics will reply that this is just the old Jawbone dressed up in new word---and remember which animal provided Samson with his weapon.