



Dr. Greenspan and the ‘Classics’

In our earlier script, we focused on the implicit collision between the Fed’s views on policy and long-standing issues in monetary theory.¹ In their statement today that lowered the Federal Funds target to 1.00 percent (a 25 basis point cut) the FOMC became positively loquacious in its accompanying remarks. The statement

- 1) refrained from an “overall” balance of risks” statement and divided the risks to growth and the risks regarding inflation-deflation into separate assessments.
- 2) backed away from previous assertion that accommodative monetary policy and ongoing growth in productivity “should foster an improving economic climate over time.” (May 6th Statement). In today’s statement, these same two drivers are now “providing ongoing support to economic activity.” (June 25th Statement).
- 3) geopolitics disappeared as a source of spending slowness
- 4) reiterated the view that the risk to sustainable growth was balanced
- 5) drew some attention to deflationary concerns that were small but likely to predominate for the foreseeable future
- 6) showed a minor disagreement in the Committee when Parry of the San Francisco Fed voiced his dissent by favoring a 50 basis point cut

On balance, to use the well-worn phrase of former Committee Statements, the Fed has stepped back from the notion that it can directly foster economic growth and returned to a somewhat more classical view that its true domain is the price level. Not entirely, of course, because this is not a Classics Fed. It does believe that it can influence real economic performance, particularly when the economy is ‘underperforming.’ We would not expect less. At the Fed, money is only sort of neutral. Please pay attention Dr. Issing!

What the Fed began in its May 6th proceeding, it enlarged today, namely separating its ‘balance of risk’ statement into two risk assessments: one to growth and one on inflation-deflation. There is also a hint that the time horizon for forecasting each of these separate targets could be different. In the May 6th statement,

“...the Committee perceives that over the next few quarters the upside and downside risks to the attainment of sustainable growth are roughly equal.” But the “time dimension” on deflationary risk is that old saw, “the foreseeable future.” Clearly, with two targets, one could have and probably should have different forecast horizons.

Perhaps the most significant change, however, are the rather striking remarks on the real and financial sectors of the economy. **“Recent signs point to a firming in spending, markedly improved financial conditions, an labor and product markets that are stabilizing.”** In our view, despite the last line in today’s statement

¹ Dr. Greenspan and the ‘Classics’ is a deliberate play on Hicks’ seminal article that brought the General Theory into the tool kit of every economist. (“Mr. Keynes and the ‘Classics,’ A Suggested Interpretation” *Econometrica* 1937).



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that ...”On balance, the Committee believes that the latter concern [‘unwelcome substantial fall in inflation’] is likely to predominate for the foreseeable future,” there is no time commitment to the Fed’s continuing support of the bond market. On the one hand, the Committee is lowering rates, ratifying previous market moves, but it is not giving an unequivocal put to Bond Traders to continue to expand the carry trade unwittingly. In our view, the Fed is choosing a very careful path between the Scylla of the Zero Bound and the Charybdis of yanking the Greenspan Put entirely. **Practitioners of the carry-trade are warned!** Apparently, Bond traders took the warning seriously. There was a massacre in the long bond market after today’s announcement. The damage to equities was minimal, but that is the next question on the horizon. It will also be very time sensitive. If the pace of earnings growth can accelerate (which it would if sustainable growth returned), maybe the gains can be preserved or even extended. The devil is in those earnings.



If we are right, a new lesson from Japan’s awful nightmare is emerging. The so-called **Hayami Put** has placed an obstacle to the Bank of Japan’s wish to clean up the Japanese financial core. Once given, it is hard to take away. The political heft of those institutions that are long **JGB’s** must be very great indeed. What is left of the financial core of Japan is leveraged to the hilt on the zero cost short money buying very low yield long paper. A rising yield curve that so often accompanies real economic growth would be an albatross around the necks of Japanese insurance companies and Main Banks, yet a rising yield curve is exactly what must accompany the return to sustainable economic growth in Japan. Be careful what you wish for in Japan.



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The Committee may indeed be correct to suggest a continued accommodative stance to monetary policy, but the tone of statement seems to be less than total. The Fed is making a gesture, but without making the promise so binding that it wends its way into a time-inconsistent policy trap. Today, the curve steepened sharply. Last year, the Fed Staff was agog with the Lessons from Japan and the basic message was Go Hard and Go Quickly. The Fed has been at the wheel of loosening monetary conditions since January of 2001. That is not exactly 'going quickly.' One lesson from the Japanese experience is that Too Little Too Late carries a big penalty because it puts monetary policy in the Put business and getting out of that business will be painful.

We view this as the beginning of a turn in U.S. monetary policy. As the risk of deflation recedes the promise of a continued guarantee to the carry trade will indeed be weakened. Only the time horizon is left to be argued.

We would not be surprised to see a new research paper from the Fed upon which Dr. Greenspan will base a new theoretical explanation of the current steering mechanism. The separation of risk statements surrounding growth and inflation is now complete. The expectations lever is out in the open for everyone to think about. Fear of a Great Liquidation was hinted publicly by only by one FOMC member who felt that a 50 basis point cut was needed. Liquidation is never is by polite central bankers. Only in their nightmares, to be sure. Stay tuned.