Munk Advisory Services
ECOMENTARY™

MAS062906

A Matter of Emphasis: creating breathing space for the FOMC

Central Banks have become too important in the daily lives of average citizens. Markets rallied on the apparent breathing space implied by the FOMC statement today---but in fact, it is the data to come that will determine forward policy. Economic policy is not a point estimate; it is a contour for forward events. While the FOMC achieved one of its goals ---regaining the freedom to act----it did not achieve greater clarity in its own targets. Despite his career-dominating calls for greater transparency on the part of the Fed, Ben Bernanke, as Chairman, has adopted a communication pattern that is more nuanced and perhaps more tentative than the Market is used to. Nuance is not transparency, and markets will not regain confidence on the basis of mere nuance.

While the FOMC raised its Fed Funds target rate to 5.25%, clearly it wished to create some breathing space for incoming data. By changing the positioning of some sentences in the May 10th text, it appears to have given itself the opportunity to get off the all too predictable course of raising rates in incremental 25 basis points steps. Many Fed commentators have assayed the need for breathing space. The sequencing of cause and effect within today's statement seems to allow incoming data to dominate the dance floor, but data dependency also allows for significant noise to play a role in policy. That hardly points to decisive leadership, however 'democratic' the colloquium at the FOMC these days!

Through a very nuanced repositioning of "growth" as "moderating" as opposed to the May 10th statement that gave high prominence to growth, if growth slows and core inflation does not rise significantly, the FOMC could pause—or even stop. That is a big "if." And to give further point to the debate between "core" and "top line," today's statement also focused on the (recent) "readings on core inflation.." This will leave analysts to wonder if growth were to continue to surge and/or "core inflation" were to continue to move up, what the FOMC response would be? Depending upon the data, it could be a rise or a pause or a fall. That is not exactly a clear guideline for markets.

The Committee became more explicit in today's statement. ("Recent indicators suggest that economic growth is moderating from its quite strong pace earlier this year…") By suggesting 'moderation' in growth, the Committee took itself off the hot seat, at least for now, and as long as the incoming data remain consistent with this assessment. The breathing space is data bound, however, because in the second operative paragraph, the FOMC concluded that "…high levels of resource utilization and the prices of energy and other commodities have the potential to sustain inflation pressures." This leaves the Committee with a full array of options for the August meeting and the market with a full range of uncertainty as to the policy outcomes. The full text reads as follows.

> The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 5-1/4 percent.
>
> Recent indicators suggest that economic growth is moderating from its quite strong pace earlier this year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices.
>
> Readings on core inflation have been elevated in recent months. Ongoing productivity gains have held down the rise in unit labor costs, and inflation expectations remain contained. However, the high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures.

ECOMENTARY™ is published for clients of **Munk Advisory Services**, **LLC**
P.O. Box 749, Horsham, PA 19044

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

> Although the moderation in the growth of aggregate demand should help to limit inflation pressures over time, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information. In any event, the Committee will respond to changes in economic prospects as needed to support the attainment of its objectives.

In May, the Committee concluded that "…some further policy firming may yet be needed to address inflation risks…" The FOMC today did state that some "inflation risks remain," despite the moderation in demand, and "additional firming ..may be needed…" There was a change in emphasis and further rises in rates are not pre-ordained but neither are they precluded.

Critics of Fed behavior will point to the absence any explicit targets or tradeoffs. Furthermore, while the market rallied on the statement, a closer read should produce some doubt. There are many more questions than answers. If uncertainty is a dampener, one suspects that the recent "re-rating" of risk will not be permanently enjoined by this policy statement. That said, continued increases in core inflation would seem to be a trigger for a more sustained or a more aggressive policy response.

A final note was the absence of unanimity in asking for permission for 25 basis point increases in the discount rate by the District Banks: San Francisco and Kansas City failed to request an increase. To this observer, this suggests that there are many differences of opinion among the members of the FOMC. It raises an old policy question: is a Central Bank best run as a democratic or an autocratic institution? Time will tell.