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Speculating on Greenspan Speculations

In attempting to forecast the direction of the Chairman's midyear testimony to the Congress, one should remember the old quip about Greenspan, to wit: 'If you are understanding what I am saying, I must be speaking too clearly!'

A review of this year's major statements on monetary policy (the February 11th report and the FOMCE statements of 1/29/03; 3/18/03; 5/06/03 and 6/25/03) shows significant confusion in reference to the Fed's forecasts for the economy; its assessment of risks for the economy and the transparency of its evaluative mechanism for assessing and responding to perceived economic risks. The most recent episode was the striking shock wave that followed the June 25th FOMC meeting at which a 25 basis point cut in the Fed Funds Target was announced in spite of the market's nearly total expectation that 50 basis points would be cut. The ensuing major escalation at the long end of the yield curve caused quite a stir because the market had felt that the Fed was now obsessed with the D word. The 25 cut was a knuckle ball, and there was quite a whiff!

Deflation has had an on again-off again history at the FOMC. The phrase "an unwelcome substantial fall in inflation," first entered the Fed's official lexicon with the February 11th Monetary Policy report. However, the phrase disappeared on March 18th, only to emerge once again in the May and June FOMC statements. Bond traders must still be a bit confused. Interspersed, were several FedSpeaks that focused on deflation. How could Bond Traders not be confused, since evidently the Fed is also uncertain as to the importance of deflation in its own deliberations? Does the Fed really believe that it is only taking out insurance? If so, how much is needed?

The Fed has also been a bit erratic as to what has held the economy back, and what prevents it from reaching self-sustaining growth. First, came geopolitics and rising oil prices. Then, at the close of the major hostilities in Iraq, the concern seemed to be that "unwelcome substantial fall in inflation," arguably obscured by a significant change in how the FOMC presents its decision. The old 'balance of risk' statements got modified with separate statements on risks to growth and risks to price level stability. Still, the public has not been taken into the Temple since the Fed has not deigned to tell markets how to compare risks to both targets and the time frame relevant for assessing those risks. Au contraire! It cannot be said that the Fed is totally transparent.

Hidden in the thicket of these verbal perambulations is the Fed's clear obsession with the state of financial market ease, and in particular, let it be said, with the financial impact of a rising equity market. That used to be a "no-no" for any respectable Central Banker, but 'times are changing.' There is no doubt that a rising equity market (or a falling equity risk premium?) has been a driver in Fed deliberations or at the very least, in those of the Chairman. Fortunately, the Chairman's unbelievable lucky streak is at work again, since despite the confusions sown with the June 25th FOMC statement, equity prices have continued to rise.

If the Congress wishes to make the Chairman squirm, they need only confront him with the statements made during this past year. They mark a painfully crooked path. Congresspeople like to demonstrate their astuteness about monetary policy, and some will undoubtedly try to show off their insights (or that of their staffs). What they should ask about is whether the Fed has trapped itself in what is known as "time inconsistency?"

If the growing ease in financial markets allowed the Fed to deny the market's expectation of a 50 point cut, how should we interpret the Fed's future course? The Fed likes the phrase "the foreseeable future," undoubtedly trying to signal the market that a rise at the short end of the curve is still a long way off. However, were the equity market to continue to rise sharply, followed by a real surge in business spending, incentives would arise for the Fed to shorten the time horizon to tightening. Were it to then to do so, time inconsistency would create reasonable doubt about the Fed's much vaunted "transparency."

This may not rise to the level of whether Iraq did or did not try to buy yellowcake uranium from Niger, but the Chairman will be walking a thin line tomorrow. It will be interesting to watch if the Congress will make him trip!

This leaves the matter of the escalating budget deficit…a favorite Greenspan hiding place. If he can take the gentle people of the Congress down that path, he can avoid too much light being thrown on time inconsistency and the virtual Alice in Wonderland quality of recent FOMC statements. We may be a bit too harsh on the Chairman. He could of course merely be a devoted disciple of Emerson's remark that "consistency is the hob-goblin of little minds."[1]

[1] As a careful critic pointed out, it was Emerson not Russell. "A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines. With consistency a great soul has simply nothing to do. " Self Reliance, 1841.