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Greenspan on the Hill: for whom has the Bell tolled?

Greenspan's testimony today struck us as unusual with its focus on inflation and the implied need for the Fed to carry forward in lessening the extent of monetary accommodation now prevalent. He was not unmindful of the "popular" concerns of the Congressmen concerning employment and the real compensation of labor, but, after a rather cursory review of the economy, and the heavy emphasis on the self sustaining character of recovery, Greenspan turned to the issue of inflation---an issue that has bothered financial markets from time to time in the spring and early summer. One has to ask, "Who was his real audience in this presentation?" In our view, the written testimony was a litmus test on accepted Central Bank conduct in a modern economy. **"Although many factors may affect inflation in the short-run, inflation in the long–run, it is important to remind ourselves, is a monetary phenomenon."** Should the Congress, members of the FOMC or the markets themselves have any doubt, he made it totally clear that "…**an environment of price stability**…" allows economic agents "…**to make decisions that best promote the longer-term growth of our economy**…"

One can ask then why Greenspan felt it necessary to recite the main catechism of central banking? A part answer would be the amount of recurring discussion, particularly among financial commentators, over the continually changing mantras used by the FOMC to communicate its assessment of the economy and the intent of monetary policy officials in the near term. As the economy has turned into a fuller recovery, the FOMC has, no less than three times, altered the way it presents its case. Markets were then left to ponder the real meaning attached to the various phrases and terms used to communicate monetary policy to the public. During this recovery, the FOMC first used its post meeting statements to provide a near total commitment to maintain monetary ease until the threat of deflation vanished; then, as it became apparent that indefinite ease was not a viable stance, the FOMC shifted to "patience" to describe when accommodation would begin to be removed. The final ambiguity was the use of "measured" (as in steps, or as in the height of the steps or in the number of steps until the last stage was reached?) in removing its record-making amount of monetary accommodation. The communications policy has not been fully satisfactory since the prime criterion of central banking is ultimately the control of inflation. His testimony today seemed to be directed to re-establishing the Fed's credentials as a member in good standing of the Club of Central Bankers---and perhaps even more importantly---to communicate to his fellow FOMC members that he is on watch, on duty and he believes!

The focus on inflation is paramount in this report despite the normal Fed review of current conditions provided in his testimony and the accompanying Monetary Policy Report to the Congress. The economy has achieved a self-sustaining recovery that is more "broad-based," and it is the recovery that is the prime reason for the somewhat unanticipated rise in inflation. Greenspan's central contention or explanation for the inflation is expanding profit margins, an analysis not widely shared among many economists. They might agree that the 'proximate' cause was the expansion in margins, but sustaining those margins would not be possible if the Fed did not underwrite sufficient monetary expansion. In fact, at a later point in the testimony, Greenspan banished the 'deflationary' threat entirely perhaps as a signal that "measured" did not include expansion which some commentators have pointed is not excluded by the phrase.

We have now returned to familiar waters. How much restraint is needed and over what time period to insure that inflation (particularly the current up tick that has come about so unexpectedly) does not undermine the long run growth potential of the economy? A fundamental issue ----did the Fed wait too long to remove monetary ease---was not addressed at all. Instead the Chairman used his rhetorical gifts to get around the question of what Federal Funds rate would be "neutral." Not surprisingly, 'you'll know it when you see it,' was trotted out once again. Meaning: if financial markets are not straying away from some sort of 'fundamental values' then the Funds rate is set at a reasonable ("neutral?") level. Doesn't that sound about right for a

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Chairman who claimed he would know a Bubble only when it was over!

The risks to the economy 's growth and its inflation prospects are the stuff of the 'dual mandate.' Appropriately, Greenspan covered the waterfront. The current softness is transitory, in his view, largely the effect of 'energy prices' that have eroded household disposable income. He thinks that energy costs will not be rising at the same rate as we go forward, defanging, as it were, some of the inflation dragon's thrust. Later in his oral Q&A, he tried to distinguish between a transitory energy price shock (such as in the late 1970's) and a permanent elevation in energy prices, resting part of the distinction on the fact that in real terms, energy costs today are lower than they were in the late 1970's despite the apparently high nominal prices.

On the substantive side, the Fed has raised its expectations of inflation by bracketing a range of 1-½ to 2% which raised by ½ % its February estimates for 2004[1] and it gave itself even more leeway in 2005 by changing to the core PCE index with a 1- ½ to 2 ½ % range. Greenspan may have transitory explanations for the missed forecast for inflation in 2004 FH, but if the inflation rate is projected to rise in 2005, a transitory explanation won't carry the day.

The comparison of the forecasts for economic growth and for the level of unemployment have also dropped, from 4-5 ½ % in the February report to 4 to 4-¾ % for 2004 and 3 ½ to 4% for 2005.[2] Some improvement, but not much, is expected for the unemployment rate, now forecast to be 5 ¼ to 5-½% in 2004, dropping to 5 to 5-½% in 2005. That is not Stagflation ---at least by the standards of the 1970's---but it clearly points to a change. Does anyone remember the "4's" when Greenspan was asked at the beginning of the year by Senator Sarbanes whether we would see those levels of unemployment again? Perhaps not during this Chairman's reign that ends in 2006.

The theory of inflation (short run variety) promulgated by the Chairman was one resting on profit margin expansion. We, among others, have had trouble buying that kind of story, even though we recognize that the ratio of profits to GDP has seemed to be beyond the range of historical experience. Clearly margins have been rebuilt, corporate balance sheets have been re-tooled and cash flows expanded to such an extent that even commercial banks have complained about poor loan growth while the economy was recovering. But the Chairman does not believe this is a sustainable equilibrium. Margins will erode to the pressures of rising labor costs---at least that is his theory.

Bottom Line: the tightening mantra has been cast into the ring for everyone to see. The sky might not fall, but rates will rise this year in a measured fashion as long as inflation does not get out of hand. Were it to do so, however, the recitation of the central banking catechism should serve as a clear warning to markets that this Central Banker will 'do his duty.' If you don't buy the profit margin theory of inflation, you may feel that more

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[1] An observant reader has pointed out that in an earlier draft, we failed to note the shift in the price index used between February testimony (PCE chain type price index) and the current price index ***du jour***, the core PCE which excludes energy and food. The February forecast was 1-1 ½ % for 2004 but the July forecast (using core PCE) was 1 ½ to 2%. Since 2004 taken as a whole featured large energy price rises, one presumes that a translation of the core PCE forecast would have added some unknown amount (say ½%) to a forecast based on using the chain PCE. What should we allow? Suppose it was ½%, in which case the equivalent forecast for 2004 (old basis) is now 2-2 ½%…or should we assume more, say a full 100 basis points? At this stage we don't know, but it is suggestive that the staff forecast is perhaps allowing for more inflation than the market has already built in.

[2] Our thanks to our reader for pointing out the typographical error in the growth forecast upper limit of 4 ¾ which was written as 4 ¼ in the earlier version.

rather than less will be fit into the course for rates this year and next.

The Chairman did do a very credible job in explaining to the Congressmen that households and firms had much better balance sheets. Raising rates while causing some pain will not dislocate the economy in his view, at least that is what he said! **"If economic developments are such that monetary policy neutrality can be restored at a measured pace, a relatively smooth adjustment of businesses and household to a more typical level of interest rates seems likely.** And, then the cover story: "**Even if economic developments dictate that the stance of policy must be adjusted in a less gradual manner to ensure price stability, our economy appears to have prepared itself for a more dynamic adjustment of interest rates.** In short, no promises, no indefinite commitment…instead, back to basics…back to Central Banking as it is normally taught. And, having confessed up front, the Fed is not to be blamed if that course has to be taken. **In either scenario, individual instances of financial strain cannot be ruled out."** While the Chairman believes that households and businesses are reasonably well prepared for a neutral monetary policy, there will be some risks if that course has to be chosen. Yet, there are risks to leaving the kettle boil too long. Having given us a profit-margin theory of short run inflation, the Chairman took his vows: **"Although many factors may affect inflation in the short-run, inflation in the long-run, it is important to remind ourselves, is a monetary phenomenon."** As we said, it is important to ask, for whom was this vow taken? For whom has the Bell tolled?