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Greenspan on the Hill: the dog that didn't bark

The divergence between "Showtime" for the Congress and insight into monetary policy-making was never broader than at this mid-year appearance (his last?) of the Chairman in this semi-annual report on monetary policy. Most economists and students of monetary policy are focused on what the Fed thinks is a 'neutral real rate' for Federal Funds (and given the then current rate of inflation, the nominal Fed Funds target). Basically, the Chairman dismissed this issue with a quote from recent FOMC statements. "***In our view, realizing this outcome [sustained economic growth and contained inflation pressures] will require the Federal Reserve to continue to remove monetary accommodation.***" Congresspeople at the hearing acted like the dog that didn't bark. They showed absolutely no concern with this issue. The House, like its sister on the Hill, is interested in playing to the crowd, showing its constituents that they are being represented or trying to appear as if they understand macro economics. They do better at the former than the latter, but markets learned very little from this testimony over what they already know. Rates will rise. How far, no one knows!

The Fed believes that the U.S. economy is in a sweet spot with better consumer and business activity, moderated inflation tendencies and continued monetary accommodation that requires further tightening. The case for that tightening really rests upon measures to contain inflation and inflationary expectations, some of which will be undoubtedly stimulated by the recent rise in energy prices and, albeit less clearly, by possible declines in labor productivity as the "slack" in the economy is used up. Greenspan is much less sure of the reasons for recent declines in productivity (and commensurate rises in unit labor costs). Both of these trends represent "uncertainties" that the FOMC will have to address as the data appear. The third is the "conundrum" of apparently low long-term rates despite a cumulative Fed Funds increase of 225 basis points over the past year.

The explanation of this apparent disparity on long term yields (or if you will the continued flattening of the yield curve) has taken some members of the FOMC into the land of the Savings Glut. The glut in world savings over world investment puzzles many, particularly in view of firm U.S. growth, energy inflation and impending fiscal pressures that will occur as retirement of the baby boom generation takes place. The Chairman is an eclectic user of economic theory. He thus trotted out the "reduced risk premium" argument that would follow from a perceived view by the investing public throughout the world that macro economic stability has undergone substantial improvements. Thus, less perceived stability risks translate into a lower risk premium that should be built into both interest rates and equity prices. The second explanation is the excess of "intended saving over intended investment," that follows when high growth occurs in nations that have very high propensities to save. An addendum to this explanation is the shift of wealth that accompanies much higher crude oil prices. Oil producing states are not spending all of their increased revenues and are instead re-cycling some of these revenues into various security markets, bidding up asset prices in the process.

The Chairman does remark that the "savings glut" tendency has been occurring over a number of years and therefore it cannot on its own be the sole explanation for his famed interest rate conundrum. He thus turns ultimately to the declining risk premium argument that comes from a market-perceived decline in risks of macro-economic instability. Comfort with the long run is also consistent with the worldwide boom in housing, manifesting an expected comfort that long-lived assets are intrinsically 'safer' today than in the past.

If there is a housing bubble that results from these trends plus improved mortgage instruments that can dice and slice consumer demand for borrowing on housing, the Chairman seems much less worried that this will pose a threat to economic stability going forward. He did not let the opportunity pass to warn lenders that when rates ultimately rise, some borrowers will be caught out in their exuberance. He does not expect this to be a major problem because of widespread securitization and also because he does not expect to see a true collapse in housing prices nationwide.

Can we glean anything from this testimony with regard to the future course of monetary policy? A bit, but not much although it does seem clearer than in the past that the FOMC will have their antennae elevated for any increases in core inflation and any continued elevation of inflationary expectations. The official report now forecasts a point estimate of 3.5% real growth instead of the higher range of 3.75-4.0% and the 2006 forecast is lowered to a range of 3.25%-3.5% instead of the point estimate of 3.5% shown in the earlier report. The core CPE forecast has been elevated 25 basis points to a 1.75%-2.0%. These new figures hedge the Fed's predictions a bit, and some will infer that they are willing to act more decisively if the 2% threshold is breached. We are not sure this is how it should be read, but we are reasonably confident that is how the market could read it. Talking one's book is not confined to market players. Policy officials like the soft jawbone as well. What seems clear is that the Fed Funds target is going to be raised, but no commitment is being made as to "neutrality." The data will have to do the talking.