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Hang together or all hang separately

Ben Franklin was once reported to have said to his co-revolutionists either they should 'all hang together or they would certainly hang separately.' Economists by training are generally not revolutionists. It is accordingly not surprising that there is huge divergence of opinion over whether the Fed will reduce the Fed Funds rate next Tuesday (August 13th) or sit still, waiting out the data flow. What is true is that the economics fraternity is not hanging together. It has a diversity of opinion, all reasonable! The most aggressive forecast is for a 50 basis point cut, but the gamut of possibilities is endless. They include a 25 point cuts; a simple change in the bias; an unusual statement by the FOMC but no change in rates on August 13th. The latest even includes a 'wait and see,' but cut 50 basis points and reduce reserve requirements at member banks if the data flow continue poorly, particularly after any fresh repercussions from the August 14th declaration date for financial certification by CEO's and CFO's. The Fed Funds market can be read to imply no change at this meeting but as much as 50 basis points by the end of the Year. It is a smorgasbord. Choose for yourself.

What it Hangs On:

Fundamentally, the Fed is data driven, not ideologically compelled, as is the ECB. The recent data have undercut the Fed's more optimistic notes delivered by the Chairman in the Monetary Policy Report three weeks ago. The big item was the GDP revisions that took more off the Long Boom and detailed a more traditional three quarter recession in 2001, but sales data for July seem to indicate hesitation on the part of consumers. It is not a one-way street, however, since autos and housing continue to boom and initial and continuing job claims can be read to indicate modest improvements in the labor market. Still, most economists have reduced their estimates quite sharply for 2H 2002 and there has been considerable sentiment for the Double Dip hypothesis. Add to that an international context that includes very slow growth in Europe (outside the UK) and little help to date by their monetary authority (ECB). And, not least, the recent and hastily organized bailout of Brazil. Were that not enough, the continuation of more corporate scandals, earnings restatements and the up-coming August 14th deadline all coming before Congress meets again and the election campaign begins. Plus Iraq. That is more than enough, perhaps too much for the Fed to work their way through. How do we see it?

Fed Tradition is a Powerful Rudder:

While the FOMC is supposedly an independent body, it almost never refuses the views of its Chairman. Were this not the case, it would be much simpler since the FedSpeak these past two weeks has indicated that most of the members (and non-voting District Reserve Bank Presidents) find the odds are for a continuing, albeit choppy recovery. They would prefer to do less, rather than more. They focus on the lags in monetary policy and the credibility of their institution. And, at least one of the newly appointed Board Members (Ben Bernanke) is quoted this morning in the Wall Street Journal that the "stock market is not the whole economy." That was in response to substantial fall in wealth that has occurred via the Stock Market. Yet the lights have dimmed a bit since the FOMC issued their no-change order at the June 26th meeting. In that statement the Committee did indeed note the recovery was proceeding "but the but the degree of the strengthening remains uncertain." That leaves the door to change ajar, and since the end of June, the bulk of

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the macro data point to continued weakness---or to put a finer point on it---strongly positive data points are remarkable by their absence. For Greenspan to move his colleagues along the path of further ease, he will have to make a case that overcomes their natural inertia to let prior cuts play themselves out. Does Greenspan have enough ammunition?

Ammunition for a Change:

Weaker consumer spending in spite of massive auto sales.
Absence of a strong comeback in private domestic investment
Poor non-residential construction activity
The Telcom Debacle
Relative constriction in the credit markets: IPO's, wide spreads, and the Brazil effect.
High Dependence of recovery on Housing and "re-fi"
Poor Global activity (Europe and Japan)
High Degrees of Uncertainty as a result of Accounting and other Corporate Governance scandals
Stock Market declines and inherent negative wealth effects
The "Disappointment" effect in the equity and credit markets
The risks of a failed recovery scenario

Forecast:

At the present time, absent the data from Advance Retail Sales due next Tuseday, we think the most likely outcome will be that the FOMC will issue a stronger statement that could include some commitment to move quickly in the event further evidence of an economic stall is developing. That could be a workable compromise between the fear of a failed recovery scenario and traditional central banking practice. We would rate the odds at 60% for this kind of outcome.

A less likely scenario, perhaps based on information not yet available, particularly with regard to credit markets, is for a 50 basis point move to quell any 'market fear' that an economic relapse will occur. Since there are expectations in the market that rates will be lower by year end, if it is thought that the recent pattern of weakness in spending is likely to persist, the FOMC is more likely to try to finish the job with one more sharp cut and hope it is then done. We rate the probability of this outcome at 25%.

The least likely scenario in our view is a move to a 25 basis point cut. It leaves the door open to all sorts of speculation and serves no useful 'announcement effect' purpose. The market would undoubtedly be confused as to whether further cuts were coming.