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Not at the Fork: the FOMC does the expected despite the turbulence

Alan Greenspan is said to be a serious baseball fan and Yogi Berra, who has more quotes in Bartlett's Business Quotations than Warren Buffet said, "When you come to a fork in the road, take it." The market should draw the correct inference: the FOMC does not believe that the economy is at a fork in the road…yet.

While the FOMC raised the Funds Rate target 25 basis points (no surprise), considering how much markets have changed since the last meeting, the change in the statement language is actually quite mild. This was the FOMC at its political best. Leaving today's statement identical to the statement of June 30 in the first and last paragraphs, the FOMC had to grapple with a "path" change, if not a fork in the road.[1] The economy has undergone a 6-6.5% correction in the broad indices; a 20% breakout in oil prices, a desultory employment report that undershoots the consensus some 108K, and evidence that inflationary pressures are still there, even if somewhat suppressed. In addition, there has been notable weakness in consumer spending and the tech market seems to be telling investors that tech spending will disappoint. The FOMC's response to this turbulence was to make what is really a modest change—a cursory recognition that the economy is softer than they had earlier forecast.

However, when the text is explicated, it is really nothing more than a promise to look at the data ---as a whole---before determining if the economy has come to a fork in the road. Were the economy at the fork, then monetary policy might need to shift gears away from moderating economy and protect against an incipient recession. You can't get to a really high probability case for a recession from the recent numbers and clearly the Fed is not going to do that…at least now. To do so would be to destroy its credibility since it is banking on reducing accommodation. It is also banking on explaining the softness in expenditure growth and payroll growth as a result of the rapid rise in energy prices.

The FOMC is not willing to abandon the "exogenous shock" model that it has of the impact of rising price of imported oil on the rest of the economy. There is, of course, quite another explanation available—namely if the oil price is really endogenous---then oil prices are being "pulled up" not pushed up be means of cartel restrictions. In our view, that is a much more plausible model, but it has the distinct implication that Stagflation is a real risk. That would be a fork in the road, but the committee deigned to take that turn at this meeting.

Their attitude may change, but a politically sensitive Chairman, as this one certainly is, would have a great deal of explaining to do were he to shift on the basis of a few data points. He will wait a much more definite data mosaic that dictates the necessity for a huge shift in the chosen 'disaccomodation' strategy.

The Fed ought not to cast itself in the role of spinning on a dime. That's not what a good Central Bank ought to do. That's not what a Central Bank is good at doing, either. If for no other reason, a plausible case can be

[1] The critical second paragraphs says: "The Committee believes that, even after this action, the stance of monetary policy remains accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity. In recent months, output growth has moderated and the pace of improvement in labor market conditions has slowed. This softness likely owes importantly to the substantial rise in energy prices. The economy nevertheless appears poised to resume a stronger pace of expansion going forward. Inflation has been somewhat elevated this year, though a portion of the rise in prices seems to reflect transitory factors.

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made that easier Fed policy has made the energy market soar. Should the Committee cave in to the pressure to ease off its current strategy, Greenspan policy will be compared to the shocks of 1973/1974 and Arthur Burns' failed efforts to reduce "real" oil prices via generalized inflation. That would subject him to Yogi's remark, "a dime ain't hardly worth a nickel any more." That's not a good legacy for the Greenspan years.

Still, the door to slowing down the pace to a neutral funds rate has been left open. "Measured" could be stretched to allow a pause during the election season. That might not be good economics, but the political appeal could scarcely be denied. Watch the data closely and we will find out if ***transitory*** vanishes from the statement next time.