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FOMC Threads the Needle: the promise of an overshoot?

The FOMC decided today to leave the target rate unchanged and at the same time sent an unusually clear commitment to the bond market it intends to stay on hold. The key line in the statement was

> **"In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period."**

Clearly the FOMC was trying on the Do No Harm hat (or at least, No Further Harm). On the back of the sharp, upward spike of interest rates since mid June, surely stimulated by the wishy-washy vagueness of the June 25th statement, the Fed has gone about as far as a Central Bank could go in the area of pre-commitment.

Parsing the statements of June 25 and August 12 leads one to think that the Fed is anxious to prevent the bond market from tearing a larger hole in what it sees as an emerging recovery pattern. The Greenspan touch is evident. The phrasing in this statement points to the firming of spending while remarking that the labor market remains mixed. This is Greenspan needle threading at its best. It allows him to be consistent with the impression he left during his July testimony on the Hill that the economy was recovering, albeit more slowly than he would have liked while he attempts to reassure the bond market. Since he has been the strong advocate of the productivity story (which is disinflationary by nature), even if growth were to pick up (as he surely believes it will), he has given himself room to leave the current level of accommodation untouched for an "considerable period." Notwithstanding that ambiguity, the last line in the first post decision paragraph tells observers not to fear a sudden outbreak of inflation even if economic growth becomes self-sustaining.

> **"Business pricing power and increases in core consumer prices remain muted."**

Translation: The Fed has plenty of room to remain loose since profits are still limited by weak pricing power and core consumer prices have not begun to rise significantly. Some analysts have gone so far as to infer a willingness of the Fed to cut again if the economic news were to suddenly turn sour. Greenspan's legendary ambiguity leaves that possibility open, if only slightly unconvincing.[1]

The key thrust, in our view, is the Committee's attempt to erase the ambiguity left over from the June 25 statement with regard to the weight to be given to the deflationary risks as opposed to the risks to growth.

> **"The Committee judges that, on balance, the risk of inflation becoming undesirably low is likely to be the predominant concern for the foreseeable future" (the justification for) "In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period."**

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[1] Greenspan has clearly read Aristotle. "A likely impossibility is always preferable to an unconvincing possibility." [**Poetics**] The problem we have is inferring whether this option is a likely or merely unconvincing!

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Bottom Line:

We know the next move for the Fed (neutral bias on both counts) but we don't know when that will come. Yet, even if the FOMC shifts to a fully neutral bias, the Fed can stay accommodative until rather firm evidence from the pricing and employment fronts appear. The Bond Market will have plenty of data to warn it of any impending raise in the Fed Funds target. Can this accommodation last until next year? Maybe. However, to know that you have to know how the economy will behave over the next two quarters and the amount of real "slack" left to be absorbed. The Fed's economic models have not yet given us certainty on that score and the Fed knows it. The Bond Market is likely to be a Doubting Thomas, even with this seeming commitment. The upcoming Jackson Hole symposium, hosted by the Kansas City Fed (the premier Monetary Conference of the year), will focus on the theme of 'model uncertainty.' The inner circle of watchers and doers that attend will have much to discuss. This has been a very difficult economic disturbance to calibrate.

At the end of the day, the market seemed to have a strong commitment that the Fed would keep the target rate intact--- until it is completely obvious that economic growth is self-sustaining. That seemingly means that this Fed is now willing to risk an 'overshoot,' and to re-calibrate at a later date. What happened to the "pre-emption" mantra? What does Dr. Greenspan really want the market to believe?

Subsequent to the statement's release, the 10-Year bond rallied (yield fell), but during the night session, some skepticism made its appearance. Once burned, twice shy? The Bond Vigilante's are a suspicious lot, aren't they? The Fed has given them good reason. Tomorrow will be an interesting test for the Fed's transparency!

10 Year US Government Bond 8/12/03