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Stormy Weather but no leaks in the boat…so far

The FOMC changed tack but not its basic course, despite recognition that stormy weather is buffeting the boat. **The bias was changed but the Fed Funds rate was left unchanged at 1 ¾%.** ("…the risks are weighted mainly toward conditions that may generate economic weakness") as compared to the balanced tack taken in the June 26th statement ("…the risks are balanced with respect to the prospects for both goals" [price stability and economic growth]. Where does that leave monetary policy going forward? All hands on deck and watch for storms!

While the Fed still sees monetary policy as **accommodative**, it recognized that storms were blowing over the current course. The economy has softened because aggregate demand has been buffeted by "weakness in financial markets" and "heightened uncertainty related to problems in corporate reporting and governance."

What do these statements really mean? We think the Fed is saying that they think that the best single point estimate on the recovery is that the economy will withstand the current storms of financial market weakness and corporate reporting and governance, **but by placement of the sources of weakness at the beginning of the statement, the Fed has told us that the Alert signal has been lit.** In short, it won't take much more from the data to force the Fed's hand. What will they look at most carefully?

Credit markets are the major focal point for the Greenspan-led Fed. The **Senior Loan Officers' Survey** should appear in the last week of August. While the Fed probably knows some of the significant results, it will need data that is also available to the public in order to make a full course turn. To make a change without publicly available data would send a panic signal to markets that the "Fed knows something" but isn't telling us what it is. That would go against the grain of the transparency standards set by the Greenspan Fed.

We note that there have been two recent appointments to the Board, Professor Ben Bernanke and long time Fed economist, Donald Kohn. Bernanke is widely known in economic circles for some penetrating research on inflation targeting. A significant contribution was made at the August 1999 Jackson Hole Conference sponsored by the Kansas City Fed. The theme of that conference was New Challenges for Monetary Policy, and Bernanke and his co-author, Mark Gertler, presented a paper entitled "Monetary Policy and Asset Price Volatility." Their research focused on the generic question of whether or not a Central Bank ought to deal with a Bubble or its deflation. The conclusions of the paper indicated that there are circumstances during which a Central Bank should move more decisively against Asset Inflation or Asset Deflation if it wishes to produce better stabilization policy. Since this economy is caught in a severe asset deflation, Bernanke's views are surely circulating among his fellow FOMC members and are being evaluated carefully by the Fed's staff.[1]

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[1] "The principal conclusion of this paper has been stated several times. In brief, it is that flexible inflation-targeting provides an effective, unified framework for achieving both general macroeconomic stability and financial stability. Given the strong commitment to stabilizing expected inflation, it is neither necessary nor desirable for monetary policy to

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There may have been insufficient data to date to cause the Fed to suddenly lower the federal funds rate but both the current FOMC statement and this kind of research provides some justification to do just that under appropriate conditions. The issues today is whether the appropriate conditions now exist. As Bernanke and Gertler put it in their paper,

> **In particular, in our model, a large positive bubble exposes the economy to the risk of a sharp market correction, with adverse effects on aggregate demand and economic activity. In the absence of an appropriate policy response, the resulting economic contraction could be quite large. A severe market drop in our model also weakens balance sheets, induces financial distress, leads to further declines in asset prices and widens spreads in bond markets.**

What that tells us is that there is a fully professional basis for the Fed looking further than the usual macro-economic data points in order to correct for the "weakness in financial markets and heightened uncertainty" that this economy now faces. Intriguingly, Chairman Greenspan's opening remarks at that conference contained the following prophetic statement:

> **If episodic recurrences of ruptured confidence are integral to the way our economy and our financial markets work now and in the future, it has significant implications for risk management and, by implication, macroeconomic modeling and monetary policy.**

The Fed is now on high alert. It will look at a very broad range of data, including measures of credit availability particularly in the business sector. The economy is mortgaged to consumer spending, but balance will require that business sector spending makes a marked change for the better and that the consumer does not fail. The whole world is watching!

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respond to changes in asset prices, except to the extent that they help to forecast inflationary or deflationary pressures. "