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Central Banking History: the wages of monetary sin

One accusation thrown at the Fed in the Greenspan era is its apparent willingness to feed the Lions of Wall Street when they roar for more meat. When equity markets sink, the Lions roar, calling for easier money. Some call this 'serial bubble blowing,' but whatever it is called, responding to the roar strains the credulity of many monetary economists. If economics is the 'dismal science,' then monetary economists, particularly those with a bent toward monetary history, are surely the most dismal. They are extremely wary of costs that can come from feeding hungry lions, particularly when more discipline might do trainer and lion some good. A rising star in the hedge fund world who wonders, 'what's next in central banking,' sent the following to me? He is too young to 'remember' the Arthur Burns era and that Fed's attempt to deal with the Oil Shock of 1973.

> South Korea's central bank is my new favorite central bank. They unexpectedly CUT rates citing higher energy prices and lower IT spending. All 13 surveyed by Bbrg expected rates to stay at 3.75 but they lowered it to 3.5. Most don't expect any other Asian CB's to follow, but they certainly won't be hiking anytime soon. Kospi up 1.8% and it seems to have found a bottom. Kospi often leads NDX, so heads up. Korean 3yrs were -19bps while 10's were -13bps to record lows. Even the ECB is now admitting that energy costs may hurt growth! Crude is at $45 right now, a daily new record high. WMT reported earnings 1c above expectations but sales were a little light. SPU has been getting hit since the release. Retail sales are expected to rise 1.2/.4; Liscio report sees 1.1/.3; SMRA sees 1.4/.1. The chart shows yoy ex auto plunging last month after being up seven straight months and 12 of the last 13. We're number 2! (for now)Mitsubishi U FJ will merge effective 10/1. **Citigroup Global Markets 8/12**

What's the bottom line? Oil Prices up and the Korean Central Bank cuts the rate! Good thing or bad thing?

Many monetary economists and historians trace the beginnings of stagflation in the 1970's (The Great Inflation, as it is sometimes called) to the kindling of inflationary expectations fanned by the fires of excessive monetary creation. Ostensibly, it just seemed like a good thing to 'defeat' the rise in a relative price that had such a large impact on measured rates of inflation---oil and all of its petroleum derivatives as well as close substitutes. Now, if there were a way to lower a real price, by inflating the denominator, **without creating inflationary expectations** for economic agents, we would have the policy equivalent of a 'free lunch.'

Free lunches are the Holy Grail of politicians with solutions that are so obvious. Like so many other purported freebies, they are quickly replaced with hidden costs, and in the case of rising inflationary expectations, the costs can be slower growth, higher inflation and a generalized misallocation of resources. Hungry Lions, however, can set up quite a howl. Portfolio managers are deafening in their discontent with rising rates, rising oil prices and falling equity values. The higher energy costs are driven by the politics of some very disruptive regions of the world. More disruptions and higher oil prices and the louder the roar will become. It will be disguised in the form of "insufficient consumption power" because of higher gasoline prices. It will be used by firms who fail to make their earnings estimates, citing rising transportation costs or purchasing fears on the part of their customers.

Each of these separate outcries will end in a plea for the Fed to bring back the punch bowl and promise not to take it away soon---at least during the tenure of raging oil prices. Unfortunately, in my view, based on the considerable research done to explain the Great Inflation, feeding those Lions is a Central Bank's "Road to Perdition." What is needed is a very clear statement from the Chairman that he is a Seinfeld fan: "I'm not going there." The Lions will roar, but a persistent denial by the Chairman of the pleas for more meat will help quiet any buildup in inflationary expectations. In the end, the economy can avoid converting the very real problems that will be addressed by substitution into the very difficult problem of Stagflation. The latter is a many-headed hydra as the late 1970's and early 1980's proved. Paul Volker, playing Hercules at the swamps of Lerna, succeeded in cutting off the monster's many heads, but the economy agonized through two recessions in five years before inflation was tamed. Surely the FOMC should chant, "We're not going there," if they have a choice.

It may seem silly to worry about such an outcome when it appears there is a considerable fraying of confidence about the 2nd Half 2004. The equity markets have been pummeled, and it is easy to point to the 50 basis points of tightening that the Fed has engendered as one cause of the equity collapse. We do not view that as a correct causal chain. Two fears stand out in our view. First the escalating oil price caught many traders by surprise. After all, even the Chairman spoke about inflation as somewhat transitory and acknowledged the connection between rising oil prices and rising price indices.

Unfortunately, when the Fed uses energy prices as a prima facie cause of GDP shortfalls and less employment growth than anticipated, it can only confuse investors. While this ***may be*** one of the reasons for the 'forecasting failure,' growing uncertainty is more likely to be the culprit. Worse, in our view, by drawing what may be a spurious connection between higher oil prices and generalized inflation, it suggests that relief comes when oil prices come down. But there's a catch in that reasoning. If oil prices continue to rise, as they have since the Chairman's July Humphrey-Hawkins testimony, the market is led over the cliff by the Chairman's own reasoning chain.

The continuing dramas in Iraq, Russia and Venezuela together with the erosion of sufficient surplus capacity in the world oil production system has made all markets rightfully nervous. Those are 'real causes,' not monetary events and in and of themselves should not give rise to inflation in the usual sense. However, a long build-up of liquidity, which was the weapon the Fed used to fight deflation, has undoubtedly produced considerable fuel for commodity price rises. To suggest, as the Chairman has done, a connection between the slowdown and the rising oil price only reaffirms the tenuousness of trader confidence in equity valuations. The longer the oil price deviates from what was expected, the worse it gets. The fact that a rising oil price (and other commodity prices as well) comes at the end of an enormous monetary expansion is sometimes forgotten, certainly by the Lions who call for more meat. Hopefully, the essential connection will not be ignored by the FOMC who should be able to look beyond the noise and remember the fire drill.

The Fed has been trying to sail its boat between two rocks in the channel, increased spending triggered by more credit, and rising prices coupled to less than zesty employment growth. The Fed knows it has to stay away from the rocks that center around too much money chasing too few goods, but it also must have courage to face political pressure for job growth. It doesn't control the latter, no matter how loud the Lions of Wall Street roar. It can control the former, but that will increase the noise level, at least in the short run. So, Chairman Greenspan, keep your hand steady on the tiller and stay with the course. There's more rough sailing ahead. The last time a Chairman got too close to the political pressures of 1600 Pennsylvania Avenue and Wall Street, it took nearly 20 years to restore the credibility of the vessel (the Fed) as well as its helmsman. No time to ditch the sailing manual now!

What the Fed should be doing is to avoid characterizing the inflation that has occurred as 'transitory,' (it cannot know that), but make sure that markets understand the critical difference between a rising oil price and generalized inflation. Part of that "credibility thing" is to stay with sound economic theory and not just invent a new hypothesis because it is convenient. What gives markets confidence is their ability to predict what the Fed will do. That is what we really mean by a good communications policy. Policy is more than just changing a rate. It also consists of a continuous and clear message about goals and instruments. That is the discipline that the Lions must come to understand. They must know they cannot have their way and the trainer is the one who disciplines the act. On with the show!