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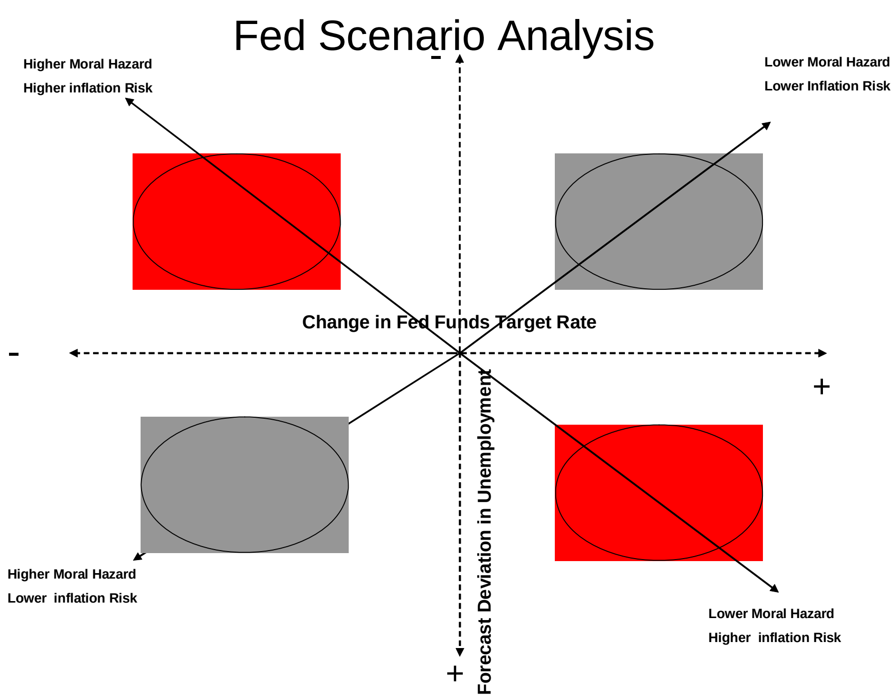
Breaking Eggs: the Bernanke recipe book

Uncle Ben is in the kitchen today and he faces a real dilemma. There are no easy choices. How much pain and who bears the pain will hinge on the FOMC decision today and those that follow in logical sequence. The Fed has to make a Scenario Choice and to juxtapose risks that are hard to weigh. More ease leads to higher moral hazard for any given forecast of where the economy is at present and where it is going based on the current policy setting. Less ease means lower moral hazard but higher risks that the economy will slip into recession. Based on his writings, Bernanke surely has some concerns about allowing current credit conditions to create a recession, or something more serious depending upon the fall out from the sub-prime lending mess. Based upon recent speeches and earlier writings, other FOMC members have differential assessments with regard to the risks to the economy of a more serious credit interrupt as opposed to the risks of validating earlier but perhaps unwise lending decisions made by credit market participants. Underlying all of this is an implicit behavioral scenario that connects inflationary expectations and the probabilities of lower or higher inflation that stem from changes in the current policy settings.



As the target Federal Funds rate is pushed lower, for any given assessment of likely unemployment in the future, the risks to the economy from shedding its now well-anchored inflation expectations must grow. How fast those risks climb is a voyage into unknown waters. Recently, Professor Allan Meltzer has laid out a reminder of the 'bad old days,' when former Chairman Arthur Burns thought there was a tradeoff between inflation and unemployment. That mythology is no longer in vogue, because we all accept that there is not a "long run Philips curve." Bernanke knows that. What he doesn't know with certainty, however, is where the economy is likely to head at the current policy setting. He will have to refer to the best available forecasts

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tempered with anecdotal information gleaned from a wide array of contacts with business decision makers and forecasters of consumer behavior. Until now, he has voiced some confidence that the current policy settings will lead to a soft landing with lower growth and well-anchored inflation expectations. We don't know, and perhaps will not know at this point, even when the rate decision is announced this afternoon. This is scenario analysis with high level consequences, an imperfect set of tools in an uncertain world.

Our diagram above is meant only to characterize the complexity, but it does not eliminate the underlying unknowns. We have chosen to represent the output dimension in terms of changes in the unemployment rate assuming that lower output levels and higher unemployment levels are connected monotonically. (Note that moving down the vertical axis corresponds to higher unemployment levels). Of course, the connection between output and unemployment is not written in stone either, but the presumption that they vary together is reasonable over the policy forecast horizon.

Our scenario analysis is framed in terms of instruments, not targets. We take the forecast unemployment level as an instrument and the change in the Fed Funds rate as the other instrument. That also adumbrates the options open to the FOMC since in recent weeks they have sought to "recreate an old tool" by using the discount rate and the definition of eligibility for paper that can be used for funding by Fed Depositaries. At this juncture, there still has not been a significant increase in discount window activities, and the new tool is perhaps best seen as a signal device telling the banks that they can fund their (growing?) liabilities at least in the short run at the window. This gives rise to a conjectured change in the discount rate and the possibility that this rate could be brought down to the target Federal Funds rate.

We can also look at the scenario analysis as an inference game. The scenarios could be a depiction of an FOMC consensus forecast for the economy going forward at this point in time. Given the outcome of today's policy decision (rate decision and the textual statement that will accompany the Fed Funds rate setting), we might then try to infer what the Fed "thinks" (or "forecasts," if you will) the horizon unemployment rate is likely to be.

In some ways, market players will effectively make this kind of analysis. Forecasting corporate earnings is dependent upon how strong the market thinks the economy will be like over the next 12- 18 months. We may learn from the market's reaction over the following few days what the market has gleaned from the policy outcome in terms of the Fed's thinking about the future course of the economy. Bond and equity markets need to have some sort of a picture of what lies behind the Fed's thinking, the recipe so to speak for Uncle Ben's omlette. How well they are able to draw these inferences will be highly dependent upon the statement released this afternoon. Hopefully, the oft-emphasized wish for transparency will shine through along with the rate decision.

Our own forecast is that the downside risks of economic decline and the attendant implications for housing prices as the economy winds down will trump earlier concerns of moral hazard and inflation. We think the FOMC will vote to lower the Fed Funds rate by 25 basis points and cut the discount rate by more than 25 basis points to further encourage banks to fund any contingent liabilities that are likely to emerge from their conduit lending programs. We also think that there is some likelihood that the Fed will announce a large currency swap with the ECB in the hope of providing more dollar funding for European banks and thereby depress the Libor spreads over US funds.

These moves will not come without criticism that the Fed is going to re-inflate the Bubble to get out of the problems created by the bursting credit cycle. As Joe Lewis once said, "He can run but he can't hide." Uncle Ben is going to make an omelet today and he will have to break some eggs to do it.