Munk Advisory Services

# ECOMENTARY™

MAS092006

## A Patient and (still) Passive Fed

The FOMC stood pat today, leaving its Federal Funds target rate at 5 ¼ percent. Its accompanying statement suggested little in the way of a course change, with perhaps a bit more focus on the longer term implications of a “cooling of the housing market” on economic growth. Clearly by placing the housing market to the front of its statement, the Committee is indicating that it feels housing is the key to a soft landing. By implication, a collapse in the housing market could be the trigger that gets the Fed to lower rates in the future.

The Committee noted the likely moderation of inflation pressures adding the “reduced impetus from energy prices” as an additional source of the moderation. Lower energy costs, like cooling of the housing market, are now the two central drivers of the moderation that the Fed sees. By setting these two factors out more explicitly, the Fed seems to suggest that these two factors are the central pivots in its calculus of policy restraint. A reversal of one or both might be the trigger for a change in policy direction going forward. Presumably the weighting of each factor would have some bearing as to how the Fed would react to future developments. One might even make the case that continued declines in energy prices and further deterioration in housing could stimulate the Fed to actually lower rates. However, the long period of higher than desired core inflation rates and the continuation of higher inflationary expectations should keep the Fed away from ease in the very near future.

While the Committee acknowledges that some inflation risks remain, the overall tone of the statement is one of comfort with the current degree of monetary restraint, although Jeffrey Larker, of the Richmond Fed, continued his advocacy of a further tightening in the Funds rate by 25 basis points.

The current statement’s choice of language seems consistent with the view that the Bernanke Fed is both more democratic and less formulaic in its statements, a communications policy that is to be applauded. Vice Chairman Kohn’s report on communications policy is supposedly due this month. It will be interesting to see what the Vice Chairman suggests as forward communications policy in light of a less formulaic Fed.

With crude oil dropping to nearly $60 today (down from the near $78 high), the Fed’s restraint seems to be getting some assistance from an external source. Together with sharp deterioration in housing, the market’s focus is no longer on whether the Fed raises, but if and when it begins to cut, while the Fed has left itself plenty of room to raise, were the data to suggest that inflation is still a threat.

It has been our view all along that Bernanke’s view was to avoid tightening too much and we have not been surprised that the Fed is now standing pat. Likewise, Bernanke is strongly committed to some sort of explicit numerical inflation target and that should rule out a rapid shift to monetary ease. He will want to be very sure that the fires of inflation are clearly banked and that inflationary expectations have begun to recede before he shifts gears to a policy of ease. The fact that both the bond and stock markets are signaling easier financial conditions will allow the FOMC more time to deliberate slowly before making a shift to ease.

**ECOMENTARY**™ is published for clients of **Munk Advisory Services**, **LLC**
P.O. Box 749, Horsham, PA 19044

Website www.ecomentary.com. Contact: munkb@ecomentary.com