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The Fed is going higher---the Minutes make it absolutely clear

Our analysis of the September 20th, 2005 FOMC meeting raised the issue of market misunderstanding. "We had always thought that if the Fed paused they would send a very uncertain signal to the market, as if to say by such hesitation, 'we see something out there that could be troubling!' Today's release of the Minutes of that meeting confirmed the conjecture. "

> **"A pause in policy tightening at this meeting had the potential to mislead the public both about the Committee's perception of the fundamental strength and resilience of the economy and about its commitment to fostering price stability."**

We draw two key conclusions. First, the Committee's fundamental assessment of the economy is one of substantial strength, unlikely to be thrown off by the Katrina/Rita hurricanes despite the devastation wreaked. The timing of growth, quarter by quarter, may be affected, but the trend is largely intact. Second, and perhaps more importantly, the Fed continues to focus on the threats to stability that could flow from inflation. The Fed seems to think that while the inflation threat from energy prices is conjectural, it could arouse further expectations of inflation and that would force the Fed to be even more responsive (both timing and levels). Precisely to avoid being "forced" into more extreme action, a pause in September could have been dangerous and perhaps counterproductive to achieving a smooth glide path to monetary stabilization policy over a longer term. This focus on containing inflationary expectations still dominates the FOMC's view, and in our view, this should lead to further rate increases. Whether the pace will be "moderate" or possibly more abrupt will be data-dependent with a lively internal debate within the Fed. The Fed watches the data and samples anecdotally, leaving open the chance that Fed could indeed tighten to much if it suffers from impatience.

A perhaps more interesting tidbit concerning the potential for disrupting a moderate pace of dis-accomodation is the FOMC's explicit mention of the "worrisome loss of fiscal discipline." This is a path full of danger. If the Congress cannot control spending, the Fed could be forced to act by **further reducing its degree of monetary accommodation.** Additional fiscal stimulus, notwithstanding the social capital needs engendered by 'Katrita' will put pressure on many resources providing fuel to a potential upsurge in inflation.

In its recognition of the "worrisome loss of fiscal discipline," the Fed now sits squarely astride an old dilemma. It cannot give up any hard won efforts to dissuade investors that its duty is primarily first and always to tackle inflation. Second, as it makes its monetary response more conditional on fiscal policy, it sets the Fed on a potential course of conflict with those who control spending. The Fed has had an arguably better record than Central Banks in Europe or Asia, in carrying out an anti-inflation stance while yet maintaining support for economic growth. That achievement notwithstanding, evoking worry on its on 'bloody pulpit' of the FOMC minutes, must puts the Fed somewhat on a collision course with the Executive and Legislative branches. To negotiate the narrow span between fiscal rectitude and monetary transparency is an intriguing legacy of Chairman Greenspan's impending retirement. It can only heighten speculation about his successor and the quality of the resolution of such a successor ever more critical.

We have seen an extensive monetary policy civil wars breakout in the EU and in Japan. The Fed should pay close attention to the lessons generated by its contemporary central banks. A "monetary civil war" is neither in the Fed's interest nor is it wise for economic policy in general. The Congress could interpret the Fed's remarks as meddlesome, but the proper reaction would be to heed the Fed's concerns on fiscal discipline. That makes the appointment of a new chairman even more interesting because the new chairman will have to navigate the controversy that can emanate from an activist Fed seeking to bring back fiscal discipline. The country will be far better off if "the national interest" drives the Administration's appointment of a new Fed Chairman. The FOMC may be watchful of inflation. The country needs to be watchful of the Administration's appointment.

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