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Monetary Policy Strategy ---Before and After the Attack

The FOMC's decision on November 6th to cut both the targeted Fed Funds rate and the Discount rate by 50 basis points was announced by a statement significantly different from the sentiments on August 21. In August, the FOMC had begun to worry about 'pre-emption,' even though the economy was weak. In the August (pre-Attack) meeting, in spite of evident economic weakness, some FOMC members were already focusing on the possibility that a policy reversal might have to come before sufficient evidence of recovery appeared! That would be pre-emptive monetary policy to be sure. Consider the following statement.

> **The members recognized that in light of the lags in the effects of policy, the easing process probably would have to be terminated before available measures of economic activity provided clear evidence of a substantial strengthening trend. In the view of some members, this point might come relatively soon. Beyond the nearer term members also envisaged the desirability of moving preemptively to offset some of the extra monetary stimulus now in the economy in advance of inflation pressures beginning to build. The members were fully prepared to act on a timely basis, but several emphasized the recognition lags that would be involved in stopping and subsequently beginning to reverse the policy easing. (FOMC Minutes of August 21, 2001).**

September 11th drastically changed these concerns, and it pushed the pre-emption issue well into 2002. The concern on September 13th (when an intermeeting conference call took place) was to establish a suitable financial safety net to prevent a payments crisis. By the 17th, monetary policy was eased sharply to counter the heightened uncertainty generated by the Attack. First, financial safety. Second, aggressive countercyclical monetary policy.

By shifting back to a 50 point cut, the Fed has placed pre-emption in the background. If the Fed errs this time, it will be on the side of "overshoot," not "undershoot." Pre-emption has vanished under continued concerns that both household and business spending is sagging. Considering the size of the proposed fiscal policy stimulus, this seems like a surprise. It is as if the Fed is saying that **both** strong fiscal policy and an attentive and responsive monetary policy is the first order of the day. We think that is the case!

We can also infer the seriousness of the Fed's current focus by the 'push-back' of the productivity story. The data on productivity will appear today and it is likely that the Fed already knows the results are not happy ones from the standpoint of unit labor costs. Normally, that kind of erosion would push a Central Bank to be more concerned about prospective inflation. Inflation, however, has been replaced by an unvoiced concern over 'deflation.' Japan's ten-year plight might not be a correct analogy—but it cannot be dismissed either!

On October 2, when the Fed moved the Fed Funds target 50 basis points lower (2.00%), the litany about productivity was repeated once again. Yesterday, the productivity message was altered significantly, by replacing the (unverifiable) contention that the underlying productivity growth tend had not changed with a clear direction to the Market to ignore the productivity numbers, at least for now.

> **The Committee continues to believe that, against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future. (October 2, 2001).**

> **Although the necessary reallocation of resources to enhance security may restrain advances**

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in productivity for a time, the long-term prospects for productivity growth and the economy remain favorable and should become evident once the unusual forces restraining demand abate. (November 6, 2001).

The Fed may have already known the productivity numbers when the FOMC met on November 6th. If so, it has told the market to consider this period an aberrant one and disregard the numbers. The Fed is focusing on Headwinds, not on Pre-emption. The probability of turning the economy around has risen…just as the probability of an overshoot sometime in 2002 has also risen. The Door for further ease has been left Open until the economy starts up once again.

Finally, the mention of "deterioration of business conditions both here and abroad," seems like an oblique but no less an imperative to other monetary institutions to get busy and do their duty! Greenspeak may translate to other partners in the new coalition! Monetary policy strategy in difficult times is not for the timid!