Munk Advisory Services

# ECOMENTARY™

MAS112205

## What the FOMC said and what it did not say

The FOMC minutes for the meeting of November 1 became even more transparent, a tendency long sought by the majority of monetary economists. It is also a sentiment well in line with the expressed thoughts of Greenspan's replacement, Professor Ben Bernanke. Our overview of the minutes suggests four themes:

(1) The economy is doing well despite the impact of Katrina and Rita with the objective data showing steady expansion of output and employment, subject to the short term disruptions of the hurricanes, and extremely modest indications of core price inflation.
(2) There are weak hints of inflationary expectations (one consumer survey and anecdotal evidence of some pass through of intermediate goods prices from business to business), but rather subdued wage and price behavior is the predominant theme.
(3) The current policy settings and the balance of risk statements are appropriate at this point**,** but the FOMC "**noted that policy setting would need to be increasingly sensitive to incoming economic data."** Amplifying the preceding statement was an explicit recognition of the dangers of an overshoot to the tightening regimen. **"Some members cautioned that risks of going too far with the tightening process could also eventually emerge."** (emphasis added)
(4) An active discussion is now ongoing regarding how policy statements issued by the FOMC are going to have to "evolve over time." The statement language "would have to be changed before long particularly those related to the characterization of and outlook for policy."

Items (3) and (4) represent new elements for markets to evaluate and translate into appropriate forecasts of both nominal and real yields. Our own view, which has differed from the apparent consensus among economists, has been that it is about as likely that the current pattern of increases will stop short of the "fives," as it is that the Funds rate will have to go above the 5.0% mark. The interest rate "conundrum" (the failure of long rates to rise significantly during this course of policy tightening) will be resolved with little increase at the long end and perhaps not much more at the short end. We will return to this theme shortly.

The current Minutes take another step along the road to Fed transparency. By exposing market observers to the FOMC's thought that the statement language is going to have to be altered at some point in the (near?) future, the market is being warned not to take the current course of removing accommodation at a measured pace as a line in the sand.

How long the current setting can remain is now even more data dependent than is normally the case for Fed policy-making. While the Committee does cite the elevation of forward measures of inflation in a recent consumer survey, there is also frequent mention of the lack of observed pass through into core rates of inflation as a general condition throughout the economy. The FOMC is rightly concerned that such pass through ***might*** occur, but cites little evidence of seeing that development so far.

**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

Prior FOMC statements have been criticized with regard to the "balance of risk" assessment, which in our view is another way of saying, what is the basis for tightening if the Committee cannot find substantial evidence of inflation becoming manifest? Clearly, the Fed, in its Greenspan denominated role as a "risk manager" is saying that the "costs" of an outbreak of inflationary expectations is significant and the "benefits" of being more than usually careful in preventing that development are large. But that is a putative statement not yet adequately supported either by the data or by the weakly referenced "forecast" by the Fed staff. Either the data change to confirm the Committee's worst fears or the balance of risk statement has to be altered. If the latter happens, current monetary policy settings cannot stay untouched.

We think the probabilities that the Funds rate will go above 4.75 have fallen significantly and that if there is an "inversion," as some fear, it could be slight and non-consequential with regard to a forecast of a recession. We also think that the Committee is giving the markets fair notice not to take the 25 points per meeting strategy as being locked in stone.

More transparency in Fed policy making has been advocated by nearly all monetary economists, but there is a price for this, particularly with an "activist" Fed. If the Fed seeks to display its own uncertainty as to the forward data flow, it also undermines the credibility of its forecasting prowess---and inherently undermines the basis for its activist, pre-emptive policy preferences.

In light of Bernanke's announced preferences for inflation targeting, notwithstanding his pledge of allegiance to the dual mandate at his recent nomination hearings, the current FOMC policy setting and the policy setting process are going to change. If Greenspan is determined to insure that 'inflation expectations keep well anchored," his predilection will be to ratchet up the Funds rate two more 25 point steps. However, other FOMC members know a new day is coming and it well might be that they will want to think ahead themselves. In our view those are the ingredients for a significantly increased probability that a pause will occur in the current policy course.

Will it come at the end of the Greenspan era or the beginning of the Bernanke term? Only the data know!