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Energy and Expectations: the FOMC surprises no one

Clearly conscious of the importance of 'staying the course,' the FOMC surprised no one with its 25 basis point rise today. Despite market concerns that the "soft patch" may continue longer than the Fed officially believes, the Fed is staying with its strategy of removing modest amounts of 'accomodation' on a "measured" basis. The leads to both the August 10th and September 21st statements were identical:

> "The Committee believes that, even after this action, the stance of monetary policy remains accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity."

The key to the policy strategy is the justification that removing another small amount of "accommodation" does not threaten the recovery. Yet, clearly the FOMC had to recognize that some things have changed over the past six weeks. The Committee thinks the economy is in better shape, and that condition obtains despite the rise in energy prices. Furthermore, inflation and inflation expectations still appear to be under control.

August 10

> "In recent months, output growth has moderated and the pace of improvement in labor market conditions has slowed. This softness likely owes importantly to the substantial rise in energy prices. The economy nevertheless appears poised to resume a stronger pace of expansion going forward. Inflation has been somewhat elevated this year, though a portion of the rise in prices seems to reflect transitory factors."

September 21, 2004

> "After moderating earlier this year partly in response to the substantial rise in energy prices, output growth appears to have regained some traction, and labor market conditions have improved modestly. Despite the rise in energy prices, inflation and inflation expectations have eased in recent months."

Going Forward

An apparent paradox is emerging in the fixed income market as the curve flattens. Short-term rates rise, but long-term rates fall! That is consistent with lowering of expectations of inflation. It is also consistent with a market view that suggests that output will not be growing as fast in the remainder of 2004 and slow growth will persist in 2005. In the best of all possible worlds, the FOMC could well be pleased since it is "twisting" when many monetary economists have always argued that a 'twist' is not possible. ["Twist" in this context means raising short rates to stem inflation or payments outflows and lowering long term rates to induce more investment spending]. When Twist was tried in 1961, it was judged a failure. Perhaps the earlier judgment needs to be reassessed. In a recent paper, Governor Bernanke (along with colleagues Reinhart and Sack) suggests that there may indeed be a role for "quantitative" strategies in so far as expectations could be harnessed to achieve a "real" change in the economy. Effectively, the current market reaction to the FOMC's change today was to 'vindicate' the importance of expectations.

Second, however, is the curious role that the energy shock now plays in the formulation of monetary policy. Fed Governor Gramlich, not usually known for speaking on monetary theory issues, made a speech this past week giving an explicit and clear outline of the need to combat inflation stemming from rising oil prices. That suggests to us that there is some unity at the FOMC. As long as oil prices are rising, it becomes more necessary for the Fed to lay out the tightening course---and that means that the Fed will tighten further going forward. How much more? That is the question. What should the shape of the 'real yield curve' be? Or, to put it another way, what is the potential output trend that the Fed is measuring against? More clarification is needed, but the current course suggests at least one more tightening this year.