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The Fed in Time of War

> "The Federal Open Market Committee decided today to keep its target for the federal funds rate unchanged at 1-1/4 percent.
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> Oil price premiums and other aspects of geopolitical risks have reportedly fostered continued restraint on spending and hiring by businesses. However, the Committee believes that as those risks lift, as most analysts expect, the accommodative stance of monetary policy, coupled with ongoing growth in productivity, will provide support to an improving economic climate over time.
>
> In these circumstances, the Committee believes 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 balanced with respect to the prospects for both goals for the foreseeable future."

The FOMC left rates and the bias unchanged today, a move that perplexed some analysts. Yet the Market seemed to take it well rising from an interday bottom of 7935.41 (DOW) at 10:52 AM to a peak of 8157.82 at 3:31 pm—well after the FOMC announcement at 2:30PM. Following the near promise of an imminent invasion of Iraq by the President in his annual State of the Union message, the market's behavior seems to suggest that the risks for investors are to the upside! Whether this is the "Quick War" scenario that replicates 1991 or not, several features of the FOMC announcement are worth comment.

- The President's State of the Union message focused on the necessity for disarming Iraq (if Iraq fails to follow the instructions of the Security Council to disarm) through the efforts of a willing coalition. The policy emphasis has shifted from "If" to "When," and the subsequent announcement that the Secretary of State will push for a Security Council resolution on February 5th suggests that the clock on Saddam Hussein has nearly run out. There are strong implications for the conduct of monetary and fiscal policy, and one of them is that the next move in interest rates is up, not down!

- The FOMC highlighted its view that the price of oil and apprehensions over the impending attack have restricted spending and job expansion by businesses, but those "headwinds" are expected to lift once the war commences and particularly if it ends very quickly. One way to read the primacy of this line of reasoning is that while the Fed is largely powerless in the face of geopolitically induced uncertainty---unless it is prepared to risk its own credibility and allow a virulent inflation to breakout through too much fiscal stimulus.

- Greenspan's recent visit to Capitol Hill that reportedly had Chairman arguing strongly against more expansive fiscal measures raises the question of why the Chairman would appear to be putting himself in opposition to the Administration? **Our view is that Greenspan thinks that the risk of deflation has receded and that monetary policy may have to become unduly restrictive if the Federal Government pursues an overly aggressive fiscal policy.** In spite of the evident slowing of spending by consumers and business this might seem surprising. But suppose that Greenspan already knows not only that the Iraq attack is "on," but that this move against Iraq is only stage two in a four-step process to fight the war on terrorism successfully. Whither North Korea and Iran? The Bush

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speech could be taken as a literal blueprint that a long war against terrorism will be waged, regardless of the consequences for the U.S. budget. Greenspan is apparently discomfited by fiscal looseness in time of war…particularly if the scope of U.S. actions could quite easily expand to include Korea.

- If this line of reasoning is correct, an oversold equity market has great risk to the upside. Further, since war finance has historically been 'inflationary,' it is not unthinkable that the longer view of the Fed may have it run a tighter policy than the market previously had been expecting.

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