



“life, liberty and the pursuit of happiness:” a proactive or reactive Fed?

As we celebrate our nation's freedom, we are reminded that the Founding Fathers told us that the **pursuit of happiness** was one of our inalienable rights. No institution in America seeks our happiness with more verve or élan than our beloved Fed. It sets its course to absolve the economy of nearly any contemporaneously perceived trouble that it deems within its reach. Neat sailing if you can do it, but is that the wisest course for the Fed?

The most recent set of data points on the U.S. economy appear to be signaling a downshift in economic activity. Even before the most recent data, however, it was apparent to the market that Fed had decided to change course and reduce the degree of accommodation in its monetary policy.. After a very robust QIV 2003, price and employment data from QI2004 indicated to the policy authorities that it was time to began the process of 'disaccommodation.' The Fed first signaled its willingness to act by re-drawing its March 16th policy statement---a statement focused on the Fed's ability to be patient in its return to a more neutral monetary policy---on May 4th. The later statement substituted the “measured” mantra for the earlier “patience” language, after much public criticism over the inherent ambiguity of the patience concept. The May 4th statement together with further testimony by Greenspan to Congress constituted the Fed's public admission that the economy was undergoing a self-sustaining recovery with the rate of GDP growth running above its potential growth rate. Perhaps more importantly, from a political economy standpoint, steady increases in job growth allowed some policy latitude to the Fed in choosing its path of normalization.

Accompanying these very positive developments, however, were rapid upticks in conventional measures of price inflation. The bond market expressed its concerns over the price data by elevating the longer end of the curve, with the 10 year and 30 year bonds reaching recent peaks of 4.096 and 4.872 on June 14th. Surprised by this unforeseen acceleration in inflation, the Fed came under significant pressure to begin tightening policy in perhaps a more vigorous manner, highlighted by bond market commentary that the Fed could be 'falling behind the curve.' Notwithstanding the Bond Bears, significant amounts of FEDSPEAK continued to speak of substantial “slack” in the economy that seemed at odds with the unforeseen amounts of inflation experienced in recent months. It became increasingly clear that the Fed would move---but less clear during early June if the Fed could continue on its preferred course of “measured” steps toward policy neutrality in the face of unexpected and unpredicted increases in inflation.

Fortunately for the Fed, perhaps, the data points toward the end of June took on a distinctly different character with slower job growth, apparent retrenchment in consumer spending and two monthly declines (May and Junes) in durable goods orders. In addition, QI2004 GDP was revised downward and beginning in the middle of the month, energy prices appeared to recede from earlier peaks (although they were sharply higher at the end of last week). However, by the end of the month, when the FOMC began its formal meetings, the talk of a 50 basis point increase had vanished as the Bond Market rallied. The June 30th FOMC statement appeared to 'give the market what it wanted now, through its careful attention to the measured pace doctrine and an increase of only 25 basis points. **June's** employment report amplified the recent pattern of slowing monthly job growth with only 112,000 jobs being added, a significant shift downward since the **March-May monthly average of 304,000** in jobs added. In fact, employment growth, the bane of the recovery in 2003, has shown steady deceleration. (See graph below). Some evidence has recently appeared that the initial uptick in inflation may have contained considerable transitory components, implicitly substantiating the Fed's own view that it was not behind the curve and that its steps could still be measured (which is a way of saying on its own, somewhat undisclosed terms).

But if the data are now consistent with the Fed's current view that 'measured" is the appropriate stance, does



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that mean that weaker data will slow the return to policy neutrality? Analysts who take a bearish stance on the validity of this recovery, are wont to think the Fed may have to even 'reverse' course, particularly in view of the common assumption that fiscal policy will become increasingly less expansive as 2004 turns into 2005. Where does the balance of risk now lie? Is the economy's recovery about to take a nosedive? Has the most recent retreat in the rate of increase in consumer spending signaled that energy prices have 'taxed' away too much consumer income to keep the economy rolling ahead on a path to fuller employment? Has the slowing of activity of China taken too much juice out of world growth and the demand for U.S. exports? Will the very slow growth in Europe be an insufficient offset to a slower Asia? Will each of these factors combine to turn the investment spending boom off, leaving a highly vulnerable economy in 2005?

The newest data points appear to be creating a mosaic of slower growth for 2004, and to be sure, QIII's numbers will be highly influenced by a slower June. This will test Fed policy because the economy has gotten accustomed to the Fed sailing its policy ship very close to the wind, responding, as it were, to the most recent data as if it were guiding a small sailboat rather than a 500,000 ton oil tanker. That proclivity raises the most fundamental of all monetary policy controversies: should the Central Bank be **discretionarily** reactive or should it be **predictably** pre-emptive?

The 'old literature' on monetary policy often couched this debate using the 'rules versus authority' metaphor, which asked if the Central Bank should operate on a well understood and widely publicized rule? Or, was it possible for a Central Bank to be extremely countercyclical (reactive), moving its policy instruments quickly as the newest data points became available.

The Greenspan Fed has become an activist Fed, arguably the most active policy shifter in the history of the Fed. It is neither a pure 'inflation targeter' nor is it bound by any simple or well-understood set of policy rules. Further, it is clear that Greenspan does not wish the Fed to be bound by a clear set of rules and prefers to read the economy's tea leaves and respond accordingly.

Several years ago, however, Greenspan spoke of 'pre-emption,' signaling that when events either here or abroad were of sufficient magnitude that they could disrupt the economy's course. In such circumstance, Greenspan argued that the Fed had an obligation to pre-empt such an untoward course. The famous September 1998 speech at Berkeley in the midst of the financial winds set off by the Russian default were based upon that notion. The U.S. economy did avoid a huge setback in late 1998 and early 1999, so it is argued, by the injection of massive liquidity in the fall of 1998. And, to prevent problems thought to derive from Y2K, late 1999 witnessed a sharp monetary expansion. When equity markets began their long unwind in March 2000, the Fed appeared to walk away from its "pre-emption" doctrine, raising rates in June of 2000.

The Fed only began its reverse course correction in January of 2001, although some had argued for an earlier intervention. The financial difficulties of the collapse of the equity bubble caused the Fed to take a very aggressive policy stance in 2001 and the tragedy of 9-11 further bolstered that aggressive stance. A durable goods boom ensued, stimulated not only by a rapid shift in fiscal policy, but by a further reduction in Fed Funds to 1.25% November 6, 2002 and to 1.00% on June 25, 2003.

As a result of these severe course corrections, some analysts have accused this Fed of being a 'serial bubble blower' by its willingness to be hugely aggressive when confronted by 'slack' in the economy. Even analysts who are less critical of the Fed, however, recognize that the Fed steers more by current conditions than by a long run model focused on a clearly stated navigation model. The central dilemma is still whether Fed policies should be for the long run or in response to short run variations to avoid currently perceived economic performance that is less than what is deemed "potential." And there's the rub. How close to the wind can a Central Bank sail? Should it respond to the most contemporaneous data, or should it set its course by a set of well-understood policy rules? In the present context, does the apparent slowing in growth of the economy now



indicate the need for the Fed to back off its return to an equilibrium real Federal Funds rate?

The wind has clearly shifted since mid May. Is this a transitory change or a new environment? A reactive Fed will act one way, a **predictable** Fed would look beyond the current slowing and return monetary policy to a tighter setting, one closer to a more normalized Fed Funds rate despite the apparent slowing. The market knows this Chairman's preferences. He is a very agile pilot. If the wind persists, history suggests he will change course settings, but would that be the right policy for the Fed going forward?

The Chairman is slated to retire at least from his Chairmanship in 2006. Despite an extraordinary record since his appointment in 1987, the Fed will continue under a new pilot who will inherit Greenspan's "activist" legacy and the consequent difficulties of creating its own navigational system that the market can understand. Can it institutionalize sailing so close to the wind without the current helmsman? We shall see.

