



A Fed With Many Tongues

The Fed and FOMC have been in a reactive mode since the unusual decision last week to cut the Federal Funds target by 50 points and move the balance of risk statement to neutral. At first, the market thought it understood the policy shift to mean that with an additional 50 basis point cut, the Fed was through for this cycle. Second thoughts began to appear even by the close of the market on November 6th. Since then, more commentary on what the Fed meant and what it truly thinks about this recession and the efficacy of monetary policy in correcting it has investors more confused. In the past two days, several speeches have amplified and deepened the market's awareness of the complexity of this recession and Fed policy to counteract it. The latest was Greenspan's statement and answers to questions at the Joint Economic Committee of the Congress. It would be hard to blame Congressmen if they were still confused as to what does the Fed really think is going on? The Fed may not be speaking with a single voice. It certainly appears to have many tongues, but investors are still waiting for the facts of recovery to appear.

Vice Chairman Ferguson spoke yesterday at the Carnegie Mellon 2003 Global Economic and Investment Outlook Conference. Trying to explain the views of the FOMC, he first set the stage by recounting the etiology of this recession and the success of monetary and fiscal measures to counteract it. One could detect Greenspan's voice lurking in Ferguson's phraseology. He started by trying to compare it to the mild recession of 1990-1991. In comparative terms, this one has been mild in its GDP decline, but the recovery from the trough has also been mild. Better than the recovery (over the same time period) in 1990-91, but still quite mild.

This cycle was triggered by a business investment retrenchment, offset after a few quarters by a sharp reversal of business inventory reduction. The policy response was a massive change in the Federal Funds rate and an ensuing explosion in mortgage refinance that has powered consumer expenditures. All this, aided by an exquisitely timed tax cut, has helped. The issue is whether this is enough of a stimulus? Employment growth has been negligible, industrial production is still not on the ascent and consumer confidence has deteriorated. In Greenspan's terms, the economy has hit a "soft spot." In fact, the capital boom that ended left the business sector with much more capital than it could use productively and the distribution of that capital among sectors and indeed firms has operated to retard economic growth. There has been an insufficient purge. The financial counterparts to this process of capital exit have been heightened corporate defaults, heightened credit spreads and a shrinkage of bank lending. Since technology spending was the driver of the Long Boom, the disruption is greatest precisely in the areas that were seen to be the strongest in 1999 and early 2000.

Then came the shocks, one exogenous and the other probably endogenous to the 'zero-interest rate environment' of the past boom. The exogenous shock was 9-11 and its aftermath, expressed in the war in Afghanistan which has since spread into a set of terrorist attacks around the world. The corporate governance shock may be been a fall-out of cheap credit, insufficient vetting of investments by private investors and some as yet unknown amount of corporate chicanery. Corporate malfeasance was sufficient at one point to cast suspicion on the entire capitalist mechanism. Even if there were only a 'few bad apples,' the applesauce made from the batch did not taste good. The scandal has finally toppled the Bush appointed Chairman of the SEC and has just now caused the resignation of the new accounting standards czar. Its not over 'til its over!

The Fed view appears to center on the heightened uncertainty created for the capital market—expressed frequently as the rise in the risk premium. Ferguson claimed the "...heightened uncertainty, and the



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very favorable prospects for inflation..." [caused the] FOMC to "...cut the target for the funds rate by 50 basis points." While the cut helped to offset the heightened uncertainty with more liquidity, in the official view of the FOMC, the spanner in the works was the change in the balance of risk statement. Taken together, there is an obvious contradiction.

If the economy required another 50 basis point cut, how did the balance of risk move to neutral? The rate cut was designed to allow the economy to work through its "soft spot," but all the while the FOMC felt that the balance of risk was improved! Ferguson let the cat out of the bag when he said, "Not everyone will agree with this view." Indeed! With soft growth so far, was this enough? Or, has monetary policy lost its punch? Ferguson then went on to assert the counterfactual (which of course cannot be proved). How would the economy have behaved had the Fed not moved so aggressively? The list of beneficiaries includes business which used the lower rates to rebuild its balance sheet and consumers who redid their mortgages and bought new cars. Bank loans and commercial paper issuance has declined, and to some extent, business cash flows have been rebuilt with higher corporate profits. All this in the context of reduced corporate pricing power and a steady increase in the import of manufactured goods whose prices seem to decline.

This environment of low inflation brings with it the fear of deflation. The Fed claims to have learned how to offset deflation by examining the Japanese experience, but the previously remote academic curiosum of the "zero bound," seems much less remote with Fed Funds at 1.25%. The answer is to cut quickly and cut hard and not to save on the ammunition. Despite the neutral bias, one could read this as a commitment to go further if necessary as the months wear on.

All of this is cyclical policy, and these measures come against the backdrop of a continuing increase in productivity, not all of which is considered cyclical. However, productivity change has a bright side and a dark side. A larger rate of change in productivity growth means that the potential growth rate of the economy is enhanced, while at the same time, if aggregate demand lags, employment opportunities will decrease. A lack of job growth will undermine personal consumption, the main driver for growth in this economy. While the Fed may be optimistic that self-sustaining growth is just around the boundary of this 'soft spot,' it cannot be sure...and it has said as much! The Fed is a believer. Now it must become a missionary to the business sector. How will the business sector respond to the call, "Gentlemen. Start your engines!" The Ferguson speech was an admirable sermon. Not everyone reading the speech will come away a convert!

While Ferguson was speaking in Pittsburgh, Greenspan was extolling the virtues of a market economy in Mexico City. Mexico's sharp turn around from its 1994/95 debacle would seem to be a sterling example of Smithian wisdom. Greenspan's speech was entitled "The Wealth of Nations Revisited." This recession has been accompanied by many catcalls from the opponents of globalization and the weaker the U.S. economy gets, the more the danger that the anti-globalizers will convince politicians to pull up their capitalist tent and camp closer to state regulation and control. Greenspan made a mildly convincing case not to give up the commanding heights with a return to interventionist tactics. One could contrast these sentiments with his critique of "Infectious Greed," earlier this year when the corporate governance crisis was at its apex. But, the bottom line of this paean to more domestic and international openness is a strong and sustainable growth performance by the United States. It is the only Pole holding up the capitalist tent, excluding China! And, when he cited the better growth performances of a number of countries, he noted (with obvious pleasure) that strong and independent Central Banks had a significant role to play in moderating any inflationary trends. He created a veritable three-legged stool: openness in international trade; strong institutional support for the rule of law and property rights; and, suitable macro policies that inhibit inflation. While Greenspan didn't say it, there is the obvious inference to be drawn by the people back home: Trust Me (and my central bank)!

Ferguson and Greenspan sang in counterpoint, but it was left to Governor Bies to allay the suspicions that have arisen over this last FOMC meeting. Hers was an ode to transparency. How the FOMC felt about



the economy and how it was designing policy to make markets understand what it has done and was prepared to do again, if the necessity arises. The Bies speech in itself is a hugely transparent account of what was tormenting the FOMC on November 6th. Soft spots here and around the other major industrial centers combined with the corporate governance and geopolitical shocks dictated a significant Fed response--in spite of the fact that the central scenario for the Fed was non-inflationary recovery.

Finally, of course, the world situation is yet another factor contributing to the overall uncertainty about near-term economic prospects. The potential for further terrorist attacks and the tense situation in the MidEast are obviously sources of concern. Moreover, Europe seems to be encountering a "soft spot" in economic activity similar to that evident in recent weeks in the United States. And, of course, the economic difficulties in Japan and South America are well known and seem unlikely to abate significantly over the near term.

“Despite the significant uncertainties, the FOMC retained an overall sense of confidence about prospects for the U.S. economy. Indeed, the FOMC statement also included the passage:

[T]he Committee believes that today's additional monetary easing should prove helpful as the economy works its way through this current soft spot. With this action, the Committee believes that...the risks are balanced with respect to the prospects for both goals [sustainable economic growth and price stability] in the foreseeable future.

Thus, barring further adverse shocks, the FOMC perceived the economy as passing through a "soft spot" at present and viewed the current stance of policy as adequate to foster the economic recovery. Let me assure you, though, that the Federal Reserve remains vigilant and stands ready, as always, to implement any changes in the stance of policy deemed necessary to ensure progress toward achieving its twin goals of sustainable economic growth and price stability.” (Governor Bies at the Canadian American Business Council, November 12, 2002)

When investors get through this litany of response to the Soft Spot, only one question remains? How does the Fed know its main scenario will prevail? And, try as he might, Greenspan was not totally convincing in his testimony to the JEC, today.

As usual, with his comprehensive command of the data, the Chairman reviewed all the main evidence, including the evidence of “a soft patch” and the “very respectable pace” of growth over the past four quarters. He pointed to some evidence of consumer slowdown after the rapid acceleration of consumer spending in the summer. He carefully reviewed the “extraction” process by which consumers had taken out some of the built-up equity in their homes, allowing them to maintain or increase consumption even in the face of a less buoyant job market. But, at the same time, he admitted that the declines in equity wealth have offset the buildup of household equity. That is a cloud on the horizon for any objective observer.

In pointing to the centrality of consumer spending, he implies a zone of uncertainty for the economy going forward since there appear to be some limits in inducing spending by extracting more equity from existing homes. Again, the issue of the efficacy of monetary policy looms large. Further, the committee wanted to talk about the risks of deflation. The Chairman did not see deflation as a likely outcome, but admitted that the Fed was watchful. Further, in answer to several questions about monetary ammunition, the Chairman pointed out to the Committee that the Fed had the experience and willingness to operate throughout the full maturity structure of Government debt. Prior to the Accord with the Treasury in 1951, the Fed had traded through many maturities and it was prepared to do so again if required.



Where does all of this leave investors? Certainly with questions and in the worst case, with severe doubts as to whether monetary policy will work or must be supplemented by more fiscal measures? The Chairman thought monetary policy will work, in spite of the new threat to the economy poised by the possibility of war with Iraq, but he was not unwilling to see even more fiscal measures. In fact, he strongly counseled the Committee not to scale back the previously enacted tax cuts. If investors were looking for absolute assurance today or yesterday, they didn't get it. What they got was the commitment that the FOMC would try again if it judged the recovery in jeopardy...and again...and again..until...

In 1931, Friedrich Hayek debated vigorously with John Maynard Keynes over the efficacy of monetary policy in the face of an investment boom collapse. Professional economists of the time rejected his critique of monetary measures to offset such a collapse, but Keynes went back to Cambridge and wrote "The General Theory of Employment, Interest and Money" This is not 1931, and the collapse of our banking system is not just around the corner. Still, a bit of luster has fallen off Sir Alan's mantle. Investors are not yet convinced that the Fed has the game in the bag. The balance of risk was changed to neutral as the Fed made its cut, but no one can escape the conclusion that considerable uncertainty as to the economy's recovery continues. Investor skepticism cannot be overcome by a many-tongued Fed. Some verifiable facts of recovery must be found!



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