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Fed Focus

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Slow and Easy, Baby

While reading the minutes of the March 22 FOMC meeting, I had a flashback experience. Nothing illegal, I hasten to add, but a flashback nonetheless, to the movie Cool Hand Luke, when the Captain bellows:

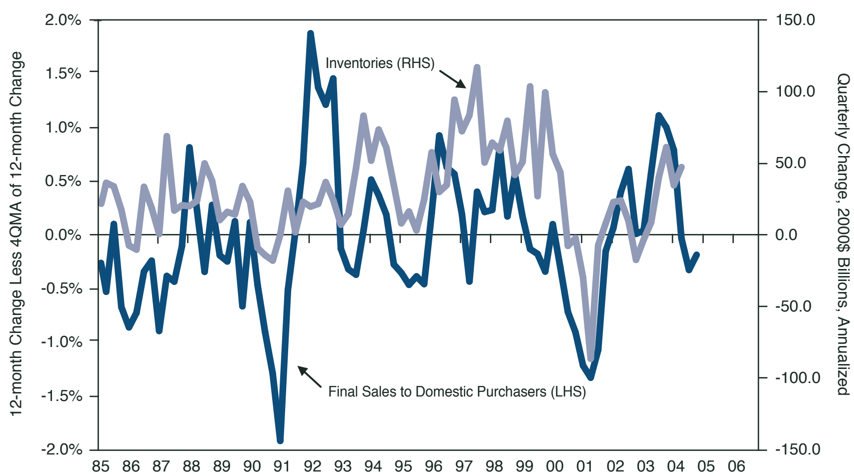
> *"What we got here is a failure to communicate. Some men you can't reach. That is, they just don't listen when you talk reasonable. So you get what we had here last week, which is the way he wants it. Well, he gets it, and I don't like it any better than you men."*

Luke, sometimes also known as Paul Newman, had just been rounded up after escaping and the Captain was mightily ticked off and wanted to put the fear of God into Luke's chain gang buddies. They, however, were only concerned about Luke's well being, proud of him for escaping, even though he had gotten caught. In particular, Luke's best buddy Dragline, soothingly intoned:

> *"Awright, buddy. You be awright. You give 'em a run for their money. Just take it slow and easy, baby. You gonna make it fine."*

Great film! And a fair facsimile of this week's dance between the Fed and the bond market. With release of the minutes, Captain Greenspan and his merry band of 18 FOMC guards tried to put fear of more aggressive Fed tightening into the hearts of the bond market chain gang. But we, like Dragline, were unimpressed, because we know in our hearts that the

Negative Momentum In Final Sales Demand Portends The Dark Side Of The Inventory Cycle



Source: Bureau of Economic Analysis, PIMCO

FOMC has no choice but to take it slow and easy.

The minutes were, nonetheless, fantastic reading, in which the FOMC angrily debates whether there are failures in the FOMC's own communication strategies. Indeed, this set of minutes was the most tortured I've read in my almost 25 years of reading such prose.

So, bear with me as I have a little fun, parodying back to Captain Greenspan and his merry band, as Luke was fond of doing. But first, here's the bottom line: **The Fed ain't gonna be hiking in 50 basis point clips. What is more, the Fed probably has only two or three more 25 basis point shots left, taking the nominal Fed funds rate into the 3%-3.5% zone, generating a real Fed funds rate in the 0.5%-1.0% zone**.

Such an outcome will be consistent with PIMCO's longstanding forecast of a secularly-lower "neutral" real Fed funds rate in a world in which the Fed is trying to secure the peace of secular price stability, after successfully prosecuting a secular war against inflation in the 1980s and '90s. Yes, we do own our priors here at PIMCO! Now to the minutes.

It Depends Upon What You Mean By "Balanced"

In January 2000, the FOMC ditched its long-standing policy of including a "bias" or "tilt" in its policy directives in favor of including a "balance of risks" assessment. There were many reasons for the change, not the least of which was that the FOMC itself could never agree as to the half-life of the "bias": did it just imply the period up until the next FOMC or did it extend beyond that?

Grey beards amongst FOMC members, as well as within the Fedwatching fraternity, tended to view the "bias" as applying only to the intermeeting period, giving the Chairman the authority to make intermeeting policy changes consistent with the "bias." Yes, there was a time when the FOMC members could sublimate their egos sufficiently to allow the Chairman to act on their behalf without checking back with them. Paul Volcker did it all the time, as did Alan Greenspan in his early years.

But over time, the Committee evolved to wanting intermeeting telephone conferences in the event that the Chairman wanted to make an intermeeting policy move. That evolution was accelerated, no doubt, by the revelation in 1993 that both Paul Volcker and Alan Greenspan had been keeping tapes of FOMC meetings without telling the members, which thoroughly ticked them off, since many (regional bank Presidents) had testified before Congress that the FOMC did not keep verbatim records of its meetings (it would have ticked me off, too!)

In the aftermath, the "bias" lost its delegation-to-the-chairman purpose and took on a new "signaling" role, a precursor to the starting, interrupting or ending of easing and tightening sojourns.

This evolution made ambiguous the precise half-life of the "bias" (or lack thereof), with consensus market opinion coming to believe that a "bias" was essentially a FOMC commitment to act in the direction of the "bias" at the next FOMC meeting (even though we wouldn't learn of such a bias until after the next meeting, at which time the minutes of the prior meeting were released. It was only in 1999, the year before the death of the "bias" that the FOMC started announcing any change in the "bias" at the end of meetings).

The FOMC didn't like the markets' presumption that a "bias" represented a commitment to act in that direction at the next meeting, so in 2000, the Committee killed the "bias" in favor of a "balance of risks" assessment on economic activity and inflation – essentially the FOMC's assessment of where the economy stood on the Phillips Curve trade-off between unemployment and inflation.

In announcing the change, the FOMC explicitly noted that the "*time frame in the new language is intended to cover an interval extending beyond the next FOMC meeting*." The FOMC was hoping that this change would debunk the notion that an unbalanced balance-of-risks assessment was a commitment at the next meeting to try to restore balance. But it was too clever by half: you can't tell the market that you are at a place on the Phillips Curve that you don't want to be without the market presuming that you will take action to get where you want to be!

We as a market viscerally understood that, and the FOMC's pattern of behavior thereafter confirmed what our guts told us. Until May 2003, that is, when the FOMC made a bold, **genuine** change to the balance-of-risks architecture: it separated unemployment and inflation, providing a balance-of-risks assessment for each alone, rather than implicitly as a trade-off function of each other.

For those never comfortable with the Phillips Curve, this was a most joyous occasion. In fact, however, this change did not imply that the FOMC was ditching the Phillips Curve. The FOMC can never do that for the simple reason that the Phillips Curve is a real time verity and monetary policy must have a real time beacon. Rather, the FOMC adopted a stand alone balance-of-risks statement so it could declare victory in its long secular war against inflation.

What a glorious day it was! Finally – finally! – the FOMC declared that inflation could be too low, not just too high. To wit, we had reached the promised land of secular price stability. Any further cyclical fall in inflation would be "unwelcome," the FOMC declared. Unwelcome!

The FOMC maintained that unbalanced balance-of-risks assessment for the next four FOMC meetings, moving back to a balanced balance-of-risks assessment in December 2003 for both growth and inflation, which has been maintained ever since. But have risks really been balanced? It all depends upon what you mean by balanced, I suppose.

Which brings us to the minutes of the March 22 FOMC released on Tuesday, which revealed that the FOMC had stiffened its definition of what constitutes "balanced," with some FOMC members wanting to simply ditch the balance-of-risks assessment altogether. That didn't happen, but an unholy compromise was agreed: risks would be declared "balanced" if the FOMC simultaneously declared that such balance was dependent upon "appropriate" monetary policy.

Well, "Gollleeee!", as Gomer Pyle used to say: If the FOMC does the "appropriate" thing, then risks will be balanced! Taken to its logical conclusion, this implies that the FOMC henceforth should – and will – always declare the balance-of-risks to be balanced, because to declare them to be unbalanced would be tantamount to declaring that the FOMC is running – or is planning to run – an inappropriate monetary policy.

Thus, the balance-of-risks assessment has been neutered: rather than being a guide post for we the markets to assess whether the FOMC needs to adjust policy, it has now become a platitude for the FOMC's commitment to act appropriately.

Which I guess would not be all that troubling if the FOMC were to give us other parameters – beyond the balance-of-risks assessment – for judging what would or wouldn't be "appropriate" policy. Call me old fashioned, but such an exercise usually starts with defining goals. And in the case of the FOMC, such an exercise should start with a quantitative definition of secular price stability; what is the appropriate zone for inflation to travel across the business cycle?

Such a definition would make explicit the reality that price stability doesn't mean stable inflation throughout the business cycle. After all, inflation is a cyclical variable and cyclical variables have a tendency to move cyclically. Even Gomer's good buddy Forrest Gump knows that!

Thus, the notion that a cyclical up tick in inflation is categorically a bad thing, which the FOMC should resist aggressively, is foolishness. Not that the FOMC should not lean against the wind of both cyclical inflation and deflation pressures. It should.

But how hard to lean must be governed both by (1) the verity that inflation is a cyclical variable in the context of (2) the secular positioning of inflation. Put more simply and bluntly, **<u>how hard the FOMC should lean cyclically against inflation should depend on where the FOMC would like inflation to be at the onset of the next cyclical recession</u>**.

During the long secular war against inflation – October 1979 to May 2003 – the FOMC always wanted each cyclical peak and trough in inflation to be below the prior cyclical peak and trough. This strategy even had a formal, fancy name: opportunistic disflation. What it was all about was waiting for recessions to opportunistically take lower inflation, while preempting (or trying to preempt!) any cyclical increase in inflation in subsequent recoveries.

This post-recession policy of preemptive tightening was best described by Alan Greenspan in 1994 when he declared: "*The hallmark of a successful monetary policy will be an inflation rate that does not rise*."

Which was cool back then, because the FOMC was quite comfortable with the notion of the next "opportunistic" recession taking inflation lower, towards the promised land of secular price stability. But with that secular objective achieved by 2003 (I would say a couple years earlier!), the FOMC must now contemplate how high it would like inflation to be when the next recession **<u>un</u>**opportunistically hits.

The FOMC implicitly – but only implicitly! – answered that question two months ago: in its semi-annual report to Congress, the Committee "innovatively" released its inflation forecast for not just one, but two years out. And for 2006, the Committee anticipates inflation in the core PCE deflator to be in a 1½%-2% zone.

That's not an official FOMC inflation target zone, I hasten to add: God forbid that Alan Greenspan would let the FOMC have an explicit inflation target zone! But as a practical matter, as many have commented, the FOMC's forecast is a target zone in drag. Accordingly, market participants rationally believe the FOMC will somehow want to make its 2006 forecast come true (come right, as my British friends say!). To wit, the FOMC has both the ability and the intention to tighten aggressively as needed to keep inflation from cyclically rising above 2%.

To me, this is nonsense. Not that the core PCE deflator might not travel in the 1½%-2% range in 2006. It might. But there is no reason whatsoever to assume that the FOMC has the ability to make that happen. Indeed, there is no reason to assume that the FOMC, in its heart of hearts, should even want that to happen. The most important **secular** imperative for the FOMC is to have a sufficient "buffer" in the inflation rate to absorb the disflationary force of the next recession, without plunging into a world of "unwelcome" disinflation.

No, I don't know when the next recession is going to hit. Nobody knows, including the FOMC. But assuming that the business cycle has not been repealed, which is a fair assumption unless you want to also assume the repeal of human nature, a recession does lie on the horizon. And the next recession will be very different than previous recessions in our adult lifetimes, in that it will be the first in the promised land of secular price stability.

America is not ready and neither is the global economy! Inflation is simply too low at the moment for either America or the world to absorb a disinflationary shock to aggregate demand, otherwise known as a recession. There simply ain't enough buffer in the inflation rate. How much is needed? I don't know, but perhaps similar to the FOMC's perspective on what constitutes a "neutral" real Fed funds rate, I do know what buffer isn't sufficient; and today's isn't sufficient.

Indeed, I submit that it is more important for the FOMC – and we in the markets – to debate the "neutral" buffer than **the "neutral" real short rate**. Doing so would, however, require the FOMC to address its failure to **explicitly** communicate its secular target zone for inflation. I'm waiting (a wait likely to extend to at least the first FOMC meeting after Mr. Greenspan's retirement).

It Depends Upon What You Mean By "Measured"

Irony of ironies, the FOMC did get both more explicit and less explicit at the same time, in its minutes regarding the definition of "measured." It means whatever they want it to mean! More specifically, the FOMC declared that the word "measured" did not *"rule out either picking up the pace of firming or pausing in the process of removing policy accommodation should circumstances warrant.*"

I suppose that is true. I also reckon that the FOMC is slicing the bologna more than a little too thinly. The FOMC knows categorically that the markets believe "measured" means 25 basis point Fed funds rate hikes at every meeting until the FOMC tells us otherwise. That's a fact, Jack.

And the FOMC knows it, which has been a source of angst for many FOMC members for a long time: a failure of communication borne of communicating too clearly! Or, as was bluntly said at the March 22 FOMC meeting: "*Some discomfort was expressed with language that related so explicitly to the likely trajectory of future policy action.*"

As a principled populist, I believe such discomfort is poppycock. I share the view held by those who won the day in keeping the word "measured" when they averred[1] that "*the Committee should, to the extent possible, provide information that would help the public anticipate the probable course of monetary policy.*"

Indeed, the FOMC is today in a self-described communications lacuna precisely because it introduced forward-looking communication *as an explicit tool of monetary policy* in August 2003, when it declared "*the Committee believes that policy accommodation can be maintained for a considerable period.*" As Governor Kohn noted in January of this year, the FOMC's objective in the summer of 2003 was "*holding down long-term interest rates.*" More specifically, Governor Kohn said:

> *"The unusual situation at that time shifted our assessment of the balance of costs and benefits in favor of a public statement about our expectations for the near-term path of policy. Markets appeared to be anticipating that inflation would pick up soon after the expansion gained traction, and therefore that interest rates would rise fairly steeply. This expectation was contrary to our own outlook. We saw economic slack and rapid productivity growth keeping inflation down for some time. Our expectations about policy also took account of the fact that the level of inflation was already low – lower than it had been for several decades. We thought that our reaction to a strengthening economy would be somewhat different this time than it had been in many past economic expansions and unlike what the markets seemed to anticipate.*
>
> *Under most circumstances, this sort of disconnect between the central bank and the markets would not be a big problem; we could compensate for the market's tendency to raise intermediate and long-term rates unduly by keeping policy easier for longer. But with the federal funds rate already at 1%, our scope for that was limited; and if the economy suffered any downward shocks, policy could reach the constraint of a zero federal funds rate, with uncertain consequences. Under these circumstances, giving markets more information about our policy inclination, and thereby holding down longer-term interest rates, seemed to be the less-risky way to stabilize inflation at a reasonable level and encourage a vigorous expansion"*
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> *I would judge the outcome to have been successful. We did influence rates to better reflect the actual path of policy; economic outcomes have been good; and, to date, our discussion of the path for rates has not constrained our actions. That is partly because we have been able to pull back gradually on the degree of commitment on our near-term actions in a way consistent*

with incoming data and without roiling markets."

I would certainly agree with Governor Kohn that the post-August 2003 era of using the rhetorical "conditional precommitment" has indeed been successful. There have been three epochs in this era: the "considerable period" interval from August 2003 to February 2004, followed by the "patient" span to May 2004, followed by the "measured" saga ever since.

Yes, these three data points do mark a new era! And I think it will last for a long, long time: once the FOMC takes a step toward greater transparency and forward-looking rhetoric, it can never – ever! – go back. This is the way it should be in a democracy.

I say this even as I agree with nay saying FOMC members that the "conditional precommitment" tool carries some negative externalities, notably the potential to nurture bubble tendencies in asset markets. It is true that risk premiums on various asset classes, as well as the slope of the real yield curve, are probably narrower today than would be the case if the FOMC was more opaque about its future plans.

Put differently, the FOMC's forward-looking language has reduced uncertainty and reduced uncertainty begets more robust risk appetites. And more robust does carry the risk, I acknowledge, of excessively robust, also known as irrational exuberance.

To me, however, this externality does not undermine the case for the FOMC using the "conditional precommitment" tool. Rather, this externality opens the case for the FOMC to be willing to publicly finger irrational exuberance when it sees it. And, indeed, Chairman Greenspan did precisely this two months ago, when he declared "low" long-term interest rates to be a conundrum.

We in the markets all knew what he was saying, even it he didn't use the phrase "irrational exuberance": sell notes and bonds, girls and boys, sell notes and bonds! And so we did.

And, I submit, such rhetoric-driven tightening of "financial market conditions" was a much preferred course of action than dropping the word "measured" and hiking Fed funds 50 basis points. If the FOMC is concerned about flexibility, as it says it is, flexible talk about asset prices is much preferred to hard-to-reverse aggressive tightening moves in the Fed funds rate. Put differently, a watering can is preferred to a fire hose when tending to both potted plants and potted speculators.

Alan Greenspan knows this intuitively. The "conditional precommitment" remains in play and I fully expect it to remain in play for a long, long time. The "measured" period will eventually give way to another interval, as did the "considerable period" and "patient" sub-epochs. But the tool itself can never be retired. Indeed, I fully expect the "measured" interval to end not when the FOMC wants to start hiking at 50 basis points clips but rather when it wants to stop hiking at 25 basis point clips!

Bottom Line

The FOMC has become wonderfully more transparent in recent years, particularly since declaring secular victory over inflation in May '03, ushering in the new tool of the conditional precommitment: forward-looking language to guide market expectations of future policy. Many FOMC members rue the day, however, when the FOMC got into the forward-looking language business.

But there can be no turning back. Sunshine is a great disinfectant and once the sun is allowed to shine in a democracy, we the people won't tolerate its shuttering. So, too, with sunshine from central banks in free capital markets: once exposed, we the markets will not tolerate its shuttering. Forward-looking FOMC language is here to stay, even if subject to shameless torturing by FOMC participants wearing smoke-colored glasses.

In fact, the FOMC might just get lucky, with incoming data presently screaming deceleration in global growth, presumably soothing the Calvinist souls of those itching to tighten with more passionate aggression. A global "soft patch" seems to be emerging, even the hawks of the world must acknowledge. What if it's not just a "soft patch" but a "soft landing"? In that case, not only will the FOMC not be tightening more aggressively, but will actually stop tightening!

Yea verily, the promised land of monetary policy neutrality lies on the horizon. Yea verily, in the fullness of time, there comes a time when time is full. Many is called but few is chosen. Many is cold, but few is frozen. Not even the FOMC hawks! Slow and easy, baby, and we're gonna make it fine.

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[1] *First time this verb has ever been used in FOMC minutes! Definition: "to allege or assert in pleading."*

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