

So Long To FOMC Transparency And Hello To Market Uncertainty

MICHAEL COSGROVE

Chairman Ben Bernanke may be guiding the Federal Open Market Committee to break two of Alan Greenspan's rules: tightening to the breaking point and making the "direction" of monetary policy so transparent that expectations worked to offset the intentions of monetary policy.

On April 27 Bernanke told the Joint Economic Committee that the FOMC may decide to "take no action at one or more meetings." Wednesday's FOMC statement included the phrase "further policy firming may yet be needed."

The FOMC appears to be positioning itself for flexibility. That may work to make market participants unsure of the direction of monetary policy.

Intentions of the direction of monetary policy became so transparent in the late years of the Greenspan Fed that they had unintended consequences on economic growth.

The concept is the same as announced price increases or decreases. An announcement that price decreases are planned in the future results in delays in buying; an announced price increase for 30 or 60 days from now results in anticipatory buying.

During periods of monetary easing, potential buyers using credit wait until the price — price of credit — gets cheaper, slowing growth more, which offsets Fed easing. During periods of monetary tightening, buyers on credit buy before the price of credit gets more expensive — adding fuel to growth, offsetting Fed tightening.

Tightening to the breaking point — a growth slowdown and/or financial mishap — was one of Greenspan's favorite benchmarks of knowing when enough is enough. Some illustrations:

Early 1994 to mid-1995:

The nominal federal funds rate increased three percentage points from February 1994 to February 1995. Meanwhile, the real funds rate had increased nearly 400 basis points from its 1992 trough. In July 1995 — six months after its February 1995 hike — the Fed lowered the funds rate, reacting to slowing economic growth.

Early 1997 through 1998:

An increase in the funds rate of 25 basis points to 5.5% occurred in March 1997, three months after Greenspan's famous "irrational exuberance" equity market reference.

Perhaps the Greenspan Fed intended a lengthy tightening cycle. But international instability and a slowing U.S. core inflation rate allowed the real funds rate to increase and the broad after-inflation dollar index to climb 25% from July 1995 to August 1998. That ended with the Long Term Capital Management blowup in August

1998. One month later the Fed started its cycle of lowering the funds rate.

Early 1999 to mid-2000:

The Fed increased the nominal funds rate 175 basis points from June 1999 to May 2000 while the real rate increased nearly 200 basis points over the same time frame. Concerns about Y2K and lingering liquidity issues from the LTCM crisis prompted the FOMC to rapidly expand the supply of sweep-adjusted high-powered money in 1999, which was the Fed's intention. This further liquefied the economy to offset adverse effects of the prior period and head off possible Y2K problems, pushing equities to an even higher level.

Mid-2000 to mid-2003:

The U.S. economy started its slowdown in the second part of 2000, but the Fed continued to hike the federal funds rate plus withdraw the liquidity added in 1999. Monetary policy actions were topped off by a slowdown in capital spending compared to economic activity and loss in market value of equities as the market crash accelerated. The slowdown accelerated and in January 2001 the Fed cut the funds rate from 6.5% to 6%. Reductions in the cost of money continued until June 2003, finally troughing at 1%. In this cycle, the FOMC at first tightened and later eased in an attempt to undo the adverse effects of their prior tightening.

By this time, the Greenspan FOMC was indoctrinated into making intended monetary policy changes transparent to consumers, businesses and investors. Because of that, anyone intending to purchase on credit during the 30 months of lowering the cost of money had the incentive to delay the decision to buy until the price of credit fell further. This further prolonged the period of slow economic growth, offsetting Fed easing as consumers, business and investors rapidly adjusted their expectations to Fed transparency.

Mid-2004 to present:

The Greenspan FOMC made intended monetary policy changes clear with the phrase "accommodation can be removed at a pace that is likely to be measured" in moving the funds rate up from 1%. Buyers on credit have been told this since 2004 until release of the recent FOMC minutes.

Anyone intending to purchase on credit had the incentive to buy before the price of credit increased more, further fueling growth and offsetting Fed tightening.

Bernanke's apparent breaking of two rules of the Greenspan Fed has resulted in bond yields moving higher, as the Bernanke FOMC added uncertainty into the bond market. Perhaps a shift is under way by the FOMC to have a more market-centered direction of Fed policy.

Cosgrove, principal at Econoclast, a Dallas-based capital markets firm, is a professor at the University of Dallas.