CHAPTER 6

Saying Oops after Assuming the Chairmanship

When the FOMC assembled at Chairman Greenspan's next-to-last meeting, it backed away from its commitment to a one-quarter-point firming. Although the statement in December 2005 reported another modest increase in the funds rate to 4-1/4 percent, no longer did it assert, as in November, that “policy accommodation can be removed at a pace that is likely to be measured.” Rather, the placement of the word “measured” was altered to no longer imply the certainty of a further imminent move. Indeed, “policy accommodation” wasn’t mentioned at all. Instead, it referenced the “further measured firming that is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance,” and mentioned that “the Committee will respond to changes in economic prospects as needed.”

After lifting the funds rate by another one-quarter point in late January, the FOMC’s statement was softer still despite the deletion of the word “measured,” in that “may” replaced “is likely to” in the phrase “some further policy firming may be needed.” The statement accordingly provided the incoming chairman more leeway, although it did repeat verbatim the phrase about the FOMC responding to changing economic prospects. Taken together the words in both statements signified that a new reactive, discretionary policy approach depending on the tenor of incoming economic data had supplanted the previous series of rote upward nudges in the funds rate. But the Committee still retained a public bias in the direction of further tightening.

When the meeting Minutes appeared on February 21, they confirmed this impression by concluding, “[A]ll members agreed that the future path for the funds rate would depend increasingly on economic developments and could no longer be prejudged with the previous degree of confidence.” Lynn Reaser, chief economist at the Investment Strategies Group, found a considerably less insulting analogy than my own description of “rote” previous firming, and it probably was more descriptive as well. “They are definitely off autopilot,” she said.

That’s why she makes big bucks and I don’t.
The statement at Greenspan’s last meeting in January again referencing the FOMC’s predisposition to firm was dubious precisely because the policy outcome no longer was all that foreseeable given that the decision depended on how incoming data would affect the outlook. The Committee’s subsequent announcements in March and May that retained the practices of January also were questionable for this reason. The wisdom of the tightening bias in a data-dependent context was about to be severely tested. Unfortunately, it can’t be said that the Fed passed this test with flying colors. In the event, investors became incredibly sensitive to each new data point and equity markets tanked in the context of heightened volatility. Shades of the FOMC’s similar mistake (discussed in Chapter 4) in May 1999.

Encountering a Communications Problem

At his first monetary policy testimony before the Congress on February 15, 2006, Chairman Bernanke emphasized the influence of new information on FOMC decisions:

Although the outlook contains significant uncertainties, it is clear that substantial progress has been made in removing monetary policy accommodation. As a consequence, in coming quarters the FOMC will have to make ongoing, provisional judgments about the risks to both inflation and growth, and monetary policy actions will be increasingly dependent on incoming data.6

At the same time he underscored that the FOMC retained an upward bias:

[T]he risk exists that, with aggregate demand exhibiting considerable momentum, output could overshoot its sustainable path, leading ultimately—in the absence of countervailing monetary policy action—to further upward pressure on inflation. In those circumstances, the FOMC judged that some further firming of monetary policy may be necessary, an assessment with which I concur. (p. 2)

Still, the dry prose of the accompanying Monetary Policy Report suggested that the FOMC under Chairman Bernanke, after another tightening move or two, could have had the luxury of sitting on its hands for a while. I’ll combine some sentences to make the point: “With the economy already operating in the neighborhood of its productive potential,” “the effects of the cumulative tightening in monetary policy should keep the growth in aggregate output close to that of its longer-run potential,” “and with longer-run inflation expectations continuing to be well anchored, core inflation should remain contained in 2006 and 2007” (p. 2). The situation described in that quote sure sounded like the proverbial optimal “steady state” about which economics professors like to lecture. (If only things had worked out that way.)

Chairman Bernanke placed the central tendencies of the two-year economic forecasts of the Board members and presidents front and center in his testimony. To be sure, in putting their forecasts together the Board members and Reserve bank presidents were asked to assume only the “appropriate” stance of monetary policy going forward. There was no way to tell what particular funds rate path the individuals may have had in mind in making their predictions. But the quoted words in the last